IT 01-4
Tax Type: Income Tax
Issue: Alternative Apportionment

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS v. **"CONGLOMERATE CORP."** Taxpayer	Docket No.	97-IT-0000
	FEIN:	00-0000000
	Tax Years	1990 - 1992
	John E. White, Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: Maryann Gall, Todd Swatzler and Mary Tait, Jones, Day, Reavis & Pogue, appeared *pro hoc vice* for "Conglomerate, Corp."; Deborah Mayer and David Dorner, Special Assistant Attorneys General, appeared for the Illinois Department of Revenue

Synopsis:

"Conglomerate Corp." ("Conglom" or "taxpayer") protested a Notice of Deficiency ("NOD") the Illinois Department of Revenue ("Department") issued to propose Illinois income tax deficiencies and penalties regarding "Conglom's" tax years ending 1990, 1991 and 1992. For the same tax years, "Conglom" filed amended returns on which it petitioned to use an alternative apportionment formula, pursuant to § 304(f) of the Illinois Income Tax Act ("IITA"), which the Department denied. "Conglom" requested a hearing regarding both protests. Pursuant to a pre-hearing order, the parties resolved all issues raised in "Conglom's" protests to the changes proposed in the Department's NOD. The only issue presented for hearing was whether "Conglom" should be allowed to use the alternative apportionment method set forth in its final petitions regarding the years at issue.

Since this matter involves a petition for alternative apportionment, the hearing was bifurcated pursuant to Department income tax regulation 100.3390(h). "Conglom" presented no evidence during the first stage, which involved the correctness of the Department's NOD as

revised by the parties' agreement. At the second stage, involving "Conglom's" petition for alternative apportionment, "Conglom" offered evidence in the form of books and records, the testimony of former and current employees and employees of its foreign subsidiaries, and the opinion testimony of "Harriett McGinty", a professor at the University of Illinois. The Department offered "Conglom" books and records into evidence, other documents, and the testimony of the Department employee who conducted the audit of "Conglom" for the years at issue. After considering the evidence adduced at hearing, I am including in this recommendation findings of fact and conclusions of law. I recommend that the Director resolve the issue in favor of the Department, that he finalize the NOD as revised, pursuant to statute, and that he deny "Conglom's" amended returns/petitions for alternative apportionment for the years at issue.

Part 1 Findings of Fact:

1. The Department's prima facie case, inclusive of all jurisdictional elements, was established by the admission of the NOD, under the certificate of the Director, showing a total liability due and owing in the amount of $478,762, and by the admission of the Denial issued to "Conglom" regarding its amended returns. Department Exs. 1-2; 35 **ILCS** 5/904(a).

Part 2 Findings of Fact:
Facts Regarding "Conglom's" Business:

2. "Conglom" is a Delaware corporation that manufactures and markets a wide variety of products throughout the world for use by consumers. Department Ex. 116 ("Conglom's" 1992 Form 10-K), p. 2; *see also*, Department Ex. 114 ("Conglom's" 1992 Annual Report), p. 22; Hearing Transcript ("Tr.") p. 127 (testimony of "William Gordon" ("Gordon"), "Conglom's" associate director of state and local taxes, *see* Tr. p. 63 ("Gordon")).

3. "Conglom" has a physical presence in 75 countries on six continents and it sells products in 175 markets. Department Ex. 114, p. 2.

4. "Conglom's" global headquarters is located in New York. Department Ex. 112 ("Conglom's" 1990 Annual Report), p. 41; Department Ex. 116, p. 2; Tr. p. 127 ("Gordon").

5. During the years at issue, "Conglom" classified its business into two general segments: (1) Household and Personal Care; and (2) Specialty Marketing. Department Exs. 112-113, pp. 22-23 of each annual report (respectively, Scope of Business and Industry Segment Data); *cf*., Department Ex. 114 p. 22 (in its 1992 annual report, "Conglom" identified the first segment as Oral, Personal and Body Care).

6. "Conglom" divides those two general business segments into five general product categories: Oral Care, Body Care, Household Surface Care and Fabric Care are included within the first general segment; and Pet Dietary Care and other miscellaneous product lines make up the Specialty Marketing segment. Department Ex. 112, pp. 4-5, 22-23; Department Ex. 113, pp. 4-9, 22-23; Department Ex. 114, pp. 22-23; *see also*, Tr. pp. 128-31 ("Gordon").

7. "Conglom's" core businesses produce different products, but share the following common elements: global presence, powerful brands, technological leadership, efficient production and country-by-country marketing expertise. Department Ex. 112, p. 5.

8. "Conglom's" business is not technology intensive, and nearly all of its products are readily made with common ingredients. Tr. p. 206 ("Gordon"). Many of "Conglom's" core products, including "Conglom" toothpaste, soap and cleansing powder involve no patented formulas. Tr. pp. 565-66 (testimony of "Patrice Lamumba" ("Lamumba"), "Conglom's" patent counsel).

Facts Regarding "Conglom's" Operations Within & Beyond the Water's Edge of the United States

9. "Conglom", together with its domestic and foreign affiliates and subsidiaries conducts a world-wide unitary business. Department Ex. 90 ("Conglom's" response to the Department's request to admit facts); Tr. p. 199 ("Gordon").

10. Generally, "Conglom" does not sell or manufacture products outside the United States. Tr. p. 128 ("Gordon"). Instead, it owns, as a traditional holding company,[1] 100% of the stock of approximately 75 foreign corporations, which perform those functions within one or more of the foreign countries in which such corporations operate. Tr. pp. 128-29 ("Gordon"), 341-42 (testimony of William Hearst" ("Hearst"), the general manager of "Conglom's" Argentine subsidiary).

11. "Conglom" maintains a manufacturing facility in almost every country in which it operates. Tr. p. 341 ("Hearst").

12. In 1990, "Conglom" owned and leased a total of 199 manufacturing, distribution, research and office facilities throughout the world, 76 within and 123 outside the Untied States. Department Ex. 115, pp. 3-4.

13. Major U.S. manufacturing facilities are located in "City #1", "State #1", and "State #2". Department Ex. 115, p. 3-4. Research facilities are also located throughout the U.S., with its major research facility in "Someplace", New Jersey. *Id*., p. 4; Tr. p. 133 ("Gordon").

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[1] I use the term "traditional holding company" to denote a company that holds the stock of other operating companies in order to manage or control such companies' activities. Peoples Energy Comm. v. Illinois Commerce Comm., 142 Ill. App. 3d 917, 924-25, 492 N.E.2d 551, 558 (1st Dist. 1986) ("The dominant characteristic of a holding company is the ownership of securities by which it is possible to control or substantially influence the policies and management of one or more operating companies in a particular enterprise. North American Co. v. Securities & Exchange Commission (1946), 327 U.S. 686, 701, 66 S.Ct. 785, 794, 90 L.Ed. 945, 956."). Holding companies, however, may also be created to serve other functions. *See, e.g.*, Golden, Intangible Issues: The Tax Treatment of Income from Intangible Assets, 18 J. State Tax'n 83, 97-100 (No. 1 Summer 1999) (the last part of the article "… examine[s] the tax planning technique of using holding companies to house intangible property and capture the intangible income apart from the actual operations of the corporation [that created the holding company]."); Rosen, Use of a Delaware Holding Company to Save State Income Taxes, 20 Tax Adviser 180 (1989).

14. Although "Conglom" has many manufacturing facilities overseas, there are still areas outside the U.S. where "Conglom" exports products. Department Ex. 115, p. 3-4; Tr. p. 341 ("Hearst"); Joint Ex. 1 (evidence deposition of "Richard Burton" (“Burton”), a longtime employee of "Conglom" or some its foreign subsidiaries, and who, during the years at issue, was the general manager of "Conglom's" oral care business for the United States market), pp. 15, 46. Such exports, however, are not significant. Department Exs. 112-114, p. 22 of each annual report.

15. Although the products themselves are not on the leading edge of technology, "Conglom" has established global recognition and acceptance of its products through years of marketing and successful advertising campaigns. Tr. p. 574.

16. In its 1992 annual report to shareholders, "Conglom" attributed its increases in sales to its strong product development and internationally known brands. Department Ex. 114, p. 3.

17. "Conglom" makes its brands and products internationally well known through advertising. *See id*.; *see also*; Post-Hearing Brief in Support of Taxpayer’s Petitions for Alternative Apportionment, p. 5 (“… Thus, "Conglom" is principally a marketing company focused on building brand quality, recognition and loyalty. …”).

18. For each year at issue, "Conglom's" advertising costs exceeded the income it received as gross royalties. Taxpayer Exs. 1-3, lines 7 (gross royalties) & 23 (advertising) of each federal return.

19. "Conglom's" principal global trademarks and tradenames include "Conglom", "Name #1", "Name #2", "Name #3", and, during 1992, "Name #4", in addition to various regional tradenames. Department Exs. 112-114, p. 22 of each annual report.

20. "Conglom's" employees work as a global team, and "Conglom's" global strategy “… is constantly reevaluated and improved.” Department Ex. 114, p. 2.

21. “Typically, senior "Conglom" management includes at least one overseas assignment, and … senior positions are filled by employees who began their career outside the U.S.”

Department Ex. 113, p. 13. "New products, new technologies and new advertising campaigns developed in one part of the world are quickly spread to others." *Id.*

22. Researchers in "Conglom's" "Someplace" New Jersey R&D facility create products for the world, and not just for a single country or market. Department Ex. 114, p. 19; *see also*, Tr. p. 585 ("Conglom" conducted research in New York with respect to liquid toothpaste targeted for the European market).

23. "Conglom" engineers located in New York's Manufacturing Engineering Technology group also work with the foreign subsidiaries to assist in implementing manufacturing processes. Tr. p. 591.

24. "Conglom" has a number of worldwide departments and programs located in New York and New Jersey, including "Conglom Business Development", "Conglom Technology Center", "Conglom Sales and Marketing", "Conglom Business Systems", "Conglom Advertising", "Conglom Legal" and "Conglom Marketing Development Program". Department Ex. 100 (printout of text retrieved from "Conglom's" web site), pp. 21-23; Department Ex. 114, p. 38; Joint Ex. 1, pp. 12, 83-84, 94, 99, 106 (Burton).

25. "Conglom's" patent department, attorneys and staff are located in "Someplace", New Jersey. Tr. p. 558. Its trademarks department and staff are located at "Conglom's" New York headquarters. Tr. p. 462 (testimony of "Conglom's" vice-president and associate general counsel for trademarks).

26. "Conglom's" global brands, "Conglom", "Name #1" and "Name #2", were all originally developed in the United States, and are used everywhere "Conglom" does business. Tr. pp. 343 ("Hearst"); Tr. pp. 546-547. Three more recent global brands, "Name #3", "Name #4" and "Name #5", were already market leaders in the United States and elsewhere before they were acquired by "Conglom". Department Ex. 100, pp. 1-4; Department Ex. 113, pp. 5-6, 8. At least one product developed overseas was later introduced into some markets within the U.S. *See* Tr. pp. 546-47.

27. During each of the years at issue, two "Conglom" subsidiaries having nexus with Illinois, ("PSI") and ("VCA-NY"), sustained losses. Department Ex. 76, pp. 84, 104; Department Ex. 79, pp. 21, 26; Department Ex. 82, pp. 57, 62; *see also*, Department Ex. 112, p. 16 (describing the functions of "PSI" and "VCA").

28. During the same years, two other members of "Conglom's" unitary group with Illinois nexus, "Conglom" and "Scrubex", had taxable income that exceeded PSI and VCA-NY's losses. Department Ex. 76, pp. 44, 96; Department Ex. 79, p. 20; Department Ex. 82, p. 56.

Facts Regarding "Conglom's" Illinois Operations

29. During the years at issue, "Conglom" and the following "Conglom" subsidiaries had the following presence in Illinois:

- "Conglom" maintained a rental warehouse and inventory in the Chicagoland area for the distribution and sale of products in Illinois, as well as a sales office.
- PSI was headquartered in "City", Illinois. PSI is the veterinary software unit of "Conglom's" line of pet care products, and it develops and markets computerized case studies to educate veterinarians and the staffs. Department Ex. 112, p. 16.
- "VCA-NY" rented a sales office in Illinois (the location of which is not disclosed by the record) from which (a subs) brand pet food, equipment and supplies were sold. "VCA-NY" is one of the members of a national distribution network (Veterinary Companies of America, Inc. ("VCA")) of "Conglom's" (sub) brand of pet care products.

Tr. p. 126 ("Gordon");[2] Department Ex. 59 ("Conglom's" schedules of owned property (by state), wages (by state), apportionment data (by state), sales by destination (by state), etc., for 1990).

30. Because of that presence, "Conglom" and two to three of its subsidiaries, (names omitted) were required to file Illinois income and replacement tax returns during the years at issue. Department Ex. 76 ("Conglom's" 1990 Illinois form 1120), p. 27 (schedule showing

[2] While "Gordon" described "Conglom's" warehouse as "small," no specific factual information regarding the comparative size or capacity of the warehouse was offered, or otherwise pointed out, by either party.

"Conglom's" domestic subsidiaries having an Illinois filing responsibility); Department Ex. 79; Department Ex. 82.

31. "Conglom" used many of the intellectual properties, the licenses of which produced the income at issue, in its manufacturing, marketing, distribution and sales operations conducted within the water's edge of the United States, and in its marketing, distribution and sales operations conducted within Illinois. Tr. pp. 254 ("Gordon"), 491, 547-48.

Facts Regarding "Conglom's" License Agreements with Its Foreign Subsidiaries and the Royalty and Dividend Income At Issue

32. As an integral part of its business of manufacturing and marketing products in its core business areas, "Conglom" licenses its patents, trademarks, copyrights and know how to foreign subsidiaries and to others. Department Exs. 49, 107-111 ("Conglom's" licenses to, respectively, its Hungarian, Philippine, South African, German and Swiss subsidiaries); Taxpayer Exs. 1-3 (line 7 of each return), 28-32 ("Conglom's" licenses to, respectively, its Australian, French, Spanish and Mexican subsidiaries); Tr. pp. 135 ("Gordon"); 356-57 ("Hearst").

33. "Conglom" licenses its trademarks and other intellectual properties to its foreign subsidiaries, and to others, so that they can manufacture "Conglom's" products overseas for sale in foreign markets. *E.g.* Taxpayer Ex. 28, pp. 24-26; Tr. pp. 128 ("Gordon"), 356-57 ("Hearst").

34. Some of the foreign subsidiaries with whom "Conglom" enters into such licenses are, like "Conglom", also Delaware corporations. Tr. p. 144 ("Gordon"); *compare also*, Department Exs. 49 ("Conglom"-prepared schedule listing corporations that paid "Conglom" royalties during the years at issue) *with* Department Ex. 85, pp. 1-2 (Department auditor prepared schedule listing, inter alia, the "Conglom" subsidiaries that were members of "Conglom's" consolidated federal return).

35. Since more than 80% of the property and payroll of some of the "Conglom" subsidiary licensees are located outside the United States, such companies may not be, and were not, included within "Conglom's" Illinois unitary group. 35 ILCS 5/1501(a)(27); Department Ex. 85, pp. 1-2. Where permissible, however, i.e., where they are incorporated within the United States, some of "Conglom's" foreign subsidiary licensees are included as members of "Conglom's" federal consolidated group. *Compare* Department Ex. 49 *with* Department Ex. 85, pp. 1-2.

36. "Conglom's" trademark department is responsible for managing the license agreements between "Conglom" and its foreign subsidiaries. Tr. pp. 462, 476. That department is located in New York. *Id.*

37. Although the license agreements vary from licensee to licensee, they all contain the same basic terms. *See* Taxpayer Exs. 28-32; Department Exs. 107-111.

38. Each license includes a schedule or schedules of the intangibles licensed. See schedules attached to Taxpayer Exhibits 28-32 and Department Exhibits 107-111. These intangibles include trademarks, tradenames, patents, registered designs and know-how. Tr. p. 132 ("Gordon").

39. The license agreements are designed to include all the intangibles owned by "Conglom", and it is not necessary to amend the license agreements to include new or acquired intangibles. Tr. p. 477.

40. All rights to intangibles acquired or developed by a subsidiary/licensee are automatically transferred to "Conglom". Tr. p. 365 ("Hearst").

41. The standard royalty rate "Conglom" charged was 5% of gross sales. *E.g.*, Taxpayer Ex. 28, p. 27 (¶ 10); *see also*, Tr. pp. 202 ("Gordon"), 397 ("Hearst"). Royalty payments are due quarterly, and before making such payments, the subsidiaries subtract from the amount due any applicable foreign taxes. *E.g.*, Taxpayer Ex. 28, p. 27 (¶ 11).

42. For book and for tax reporting purposes, "Conglom" “grosses-up” the royalties by adding back the foreign taxes withheld by the payors and paid to foreign government(s) in which the payors operate. Taxpayer Ex. 28, p. 27 (¶ 11); Tr. pp. 267-68 ("Gordon").

43. Licensees who make royalty payments to "Conglom" consider the payments to be an ordinary cost of business. *See* Tr. p. 397 ("Hearst").

44. "Conglom" considers its trademarks to be its most valuable intangible asset, and it seeks to protect its trademarks by all available means. Department Ex. 116, p. 2; Tr. pp. 205-06 ("Gordon").

45. The foreign subsidiaries register all of "Conglom's" intangibles in their assigned territory. Tr. p. 377 ("Hearst").

46. "Conglom" is responsible for protecting its intangibles both in the U.S. and overseas. Tr. pp. 463, 577, 579-80.

47. The subsidiaries play an integral part in protecting "Conglom's" intangibles in their territories. Tr. pp. 345-48 ("Hearst"), 482, 515-16. Besides registering the intangibles, the subsidiaries also report any infringements to "Conglom" in New York, after which "Conglom" in New York decides how to proceed. Tr. pp. 347-48 ("Hearst"), 463, 472.

48. There was no evidence offered to show whether "Conglom" also entered into such license agreements with its subsidiaries doing business within the water’s edge of the United States, including Illinois, although there can be no dispute that "Conglom's" tradenames and trademarks (i.e., the trademarks registered within the United States) are displayed on and used when marketing products sold domestically, including the products marketed and sold by "Conglom's" facilities in Illinois. *See* Department Exs. 112-114, *passim* (photos of "Conglom's" trademarked products); Tr. pp. 126, 315-16 ("Gordon"), 343 ("Hearst").

Facts Regarding Taxpayer's Filing History

49. "Conglom" filed federal corporate income tax returns on a consolidated basis for all three years of the audit period. Taxpayer Exs. 1-3; Department Ex. 85 (auditor-prepared schedule based, in part, on "Conglom's" consolidated federal income tax returns for years at issue) p. 4; Department Ex. 51, p. 3.

50. "Conglom" filed Illinois corporate income tax returns ("IL-1120") on a combined basis for each three years of the audit cycle, including with each of those returns a "Petition for Alternative Apportionment." Department Exs. 76, 79, 82.

51. "Conglom" also filed two Illinois Amended Corporate Income Tax Returns ("IL-1120X") for each of the three years of the audit cycle. The first amended return for each of the three years were filed on June 20, 1994 (*see* Department Exs. 77, 80, 83 (1990-1992, respectively)), and the second on August 29, 1997 (*see* Department Exs. 78, 81, 84 (1990-1992, respectively)).

52. On the state income tax returns "Conglom" filed in New Jersey during the tax years at issue, "Conglom" did not include any of the royalty income it received from its foreign subsidiaries in the numerator of "Conglom's" sales apportionment fraction. Tr. pp. 288 ("Gordon"); 699-700 (statement of "Conglom's" counsel).

53. On the state income tax returns "Conglom" filed in New York, "Conglom" did not include any of the royalty income it received from its foreign subsidiaries in the numerator of "Conglom's" business ratio calculation. Tr. pp. 289 ("Gordon"); *see also id*., pp. 272-87 ("Gordon", explaining New York state's corporate income tax method).

Facts Regarding the Department's Audit

54. The Department conducted an audit of "Conglom" for tax years ending 12/31/90-12/31/92.

55. The Department auditor agreed that "Conglom" and its subsidiaries conducted a unitary business (*see* Department Ex. 43, pp. 2-3), and included within "Conglom's" Illinois

unitary business group all companies listed on "Conglom's" consolidated federal returns, but for 80/20 companies. *Id*. p. 2; Tr. p. 181 ("Gordon").

56. The audit made certain addition and subtraction modifications to "Conglom's" federal taxable income, and allowances for nonbusiness and partnership income, none of which are contested here. *See* Department Ex. 27.

57. The Department did not adjust the royalty income "Conglom" received from its foreign subsidiaries because "Conglom" reported that income as business income and included it in the denominator of its sales factor. *See* Department Ex. 27. The Department did not seek to include any of the royalty or dividend income that "Conglom" received from its foreign subsidiaries in the numerator of "Conglom's" sales factor. Department Ex. 28.

58. When calculating the apportionment factors, the Department included whatever payroll and property expenses were attributable to "Conglom's" “Global Departments” located at its New York headquarters within "Conglom's" property and payroll factor denominators. *See* Department Exs. 19-20, 30-31; *see also* 86 Ill. Admin. Code § 100.3370(c)(3) (“income producing activity” and “cost of performance” discussed); Tr. pp. 256-260 ("Gordon", acknowledging that most states use a “cost of performance” test when determining to which state business income should be allocated, by having such amounts included in the numerator of a given state’s apportionment factor).

59. "Conglom" had payroll, property and sales of "Conglom's" oral care consumer products ("Conglom" toothpaste, etc.), household surface cleaners, personal care products, veterinary software management systems ("PSI"), and pet products in Illinois. Department Exs. 21-27, 32-38; *see also* Tr. pp. 126-127 ("Gordon"), 728 (testimony of Chris Misthos, the Department employee who conducted the audit of "Conglom's" business for the years at issue).

60. At or about the time the Department finalized its audit of "Conglom", the Department calculated "Conglom's" 1990 property factor as 0.013751, the payroll factor as 0.020673,

and the sales factor 0.038870, yielding an average factor of 0.028041. Department Ex. 1 (the NOD), p. 2. For 1991, the property factor was calculated as 0.012166, the payroll factor 0.022106, the sales factor 0.041750, yielding an average factor of 0.029443. *Id*., p. 3. For 1992 the property factor was 0.010633, the payroll factor 0.018024, the sales factor 0.049594, and the average factor 0.031961. *Id.*, p. 4.

61. The gross receipts "Conglom" received from apportionable dividends and royalties paid by its foreign subsidiaries were included in the denominator of the Illinois sale factor (sales everywhere) but not in the numerator (which measures sales attributable to "Conglom's" operations in Illinois). Department Exs. 27-28 (audit schedules for, respectively, "Conglom's" everywhere sales, and "Conglom's" Illinois sales); *see also*, Department Ex. 1, p. 6 (Explanation of Adjustments).

62. On March 28, 1997, the Department issued a notice of deficiency, which proposed to assess Illinois income and replacement tax in the amount of $289,868, statutory penalties in the amount of $67,424 ($62,961 pursuant to § 1005 of the IITA, $4,463 pursuant to § 1001), plus statutory interest. Department Ex. 1 (NOD).

63. On May 14, 1998, the Department issued a Notice of Denial denying "Conglom's" claims for refunds for all tax years 1990-1992 filed on August 24, 1997 which sought refunds for taxes proposed to be paid based upon Taxpayer's proposed alternative apportionment method. Department Ex. 2.

64. "Conglom" timely filed its protest to the Notice of Deficiency on May 21, 1997, which included petitions for alternative apportionment for all three years. "Conglom" protested several adjustments, all of which have been resolved with the exception to its Petitions for Alternative Apportionment. Department Ex. 4.

65. "Conglom" timely filed a Protest to the Department's Notice of Denial of its August 24, 1997 IL-1120Xs for 1990-1992 on July 9, 1993, requesting it be incorporated with its

Protest and Petitions for Alternative Apportionment filed with respect to the Notice of Deficiency. Department Ex. 5.

66. Prior to hearing, and based on the parties' agreed resolution of certain issues raised by "Conglom's" protest of the NOD, the Department revised "Conglom's" property and sales factors for each of the years at issue. Department Exs. 39-41 (summaries of agreed adjustments to NOD for, respectively, 1990-1992); Department Ex. 42 (schedules upon which the summaries set forth in Department Exhibits 39-41 are based), pp. 1, 6, 10. There was no dispute regarding the Department's calculation of "Conglom's" payroll factor during the years at issue. *See* Department Exs. 39-42.

67. Pursuant to the parties' agreed adjustments, "Conglom's" 1990 property factor was changed to 0.012800, the payroll factor remained 0.020673, and the sales factor was changed to 0.034008, yielding an average factor of 0.025372. Department Ex. 42, p. 1 ((0.012800 + 0.020673 + 0.034008 + 0.034008) ÷ 4 = 0.025372). For 1991, the property factor was changed to 0.011409, the payroll factor remained 0.022106, and the sales factor was changed to 0.036210, yielding an average factor of 0.026484. *Id.*, p. 6. For 1992, the property factor was changed to 0.010325, the payroll factor remained 0.018024, and the sales factor was changed to 0.034964, yielding an agreed average factor of 0.024569. *Id.*, p. 10.

68. The net effect of the agreed adjustments was that, for each of the years at issue, and after reconsidering the proposed assessment, the Department reduced the percentage of the net business income "Conglom" earned from its unitary water's edge activities that was attributable to its activities in Illinois. Department Ex. 42, pp. 1, 6, 10.

69. Specifically, for 1990 through 1991, the Department's recalculations determined that approximately 2.5% to 2.6% of the net business income "Conglom" derived from its unitary activities within the water's edge was attributable to "Conglom's" activities in Illinois. Department Ex. 42, pp. 1, 6, 10.

Facts Regarding the Purpose, Structure and Effect of "Conglom's" Proposed Alternative Apportionment Formula

70. "Conglom's" final petition for alternative apportionment for the tax years at issue asks the Director to approve its use of a fourth factor, an “intangible factor,” in addition to the payroll, property and sales factors, when apportioning its business income. Taxpayer Exs. 18-20; *see also*, Taxpayer Exs. 7 (amended Illinois return and petition for 1990), 10 (amended Illinois return and petition for 1991), 13 (amended Illinois return and petition for 1992), 14 (demonstrative exhibit describing "Conglom's" intangible factor).

71. "Conglom's" petitions assert that its fourth factor is needed to take into account the amount of business income it received in the form of apportionable royalties and dividends paid by foreign subsidiaries and others. *See* Taxpayer Exs. 7 (amended Illinois return and petition for 1990), 10 (amended Illinois return and petition for 1991), 13 (amended Illinois return and petition for 1992), 14 (describing "Conglom's" intangible factor).

72. "Conglom's" fact and opinion witnesses differ regarding whether the royalty income constitutes business income. While "Gordon" occasionally referred to the royalty income as being passive income (Tr. p. 140), he specifically acknowledged that it was business income (Tr. pp. 139, 199), while "McGinty" testified that it was passive income that had nothing to do with "Conglom's" domestic manufacturing and sales activities. Tr. p. 655 ("McGinty").

73. "Conglom's" formula defines “intangible property” as “stocks, [and] patents, trademarks, and know-how which are licensed in exchange for royalty payments from foreign subsidiaries.” Taxpayer Ex. 14.

74. "Conglom" asserts that its “… net apportionable income for [the years at issue] is attributable entirely to [dividends and] royalty income derived from its licensing of intangible intellectual property …” during the years at issue. *See* Department Exs. 78 (pp.

4, 7 (royalty income was "… the sole source of its apportionable income …"), 81 (pp. 3, 7), 84 (pp. 3, 7).

75. Because "Conglom" asserts that it is its intangible property that led to the lion's share of its total combined apportionable income during the years at issue, "Conglom's" alternative apportionment formula is designed to assign the most weight to its intangible factor. Taxpayer Exs. 18-20, p. 9 of each exhibit.

76. "Conglom" assigns a weight to its fourth factor that is equal to 50% of its "Passive Income Ratio", which term "Conglom" defines as being equal to "Conglom's" "total intangible income" divided by its "total income subject to apportionment in Illinois" Taxpayer Ex. 15; Tr. pp. 138-43 ("Gordon").

77. The remaining three traditional factors are each assigned a weight equal to one-fourth of the difference between one and "Conglom's" passive income ratio. *See* Taxpayer Exs. 18-20 (p. 9 of each exhibit); Table 1, *supra* page 22.

78. The weighting of the factors in "Conglom's" proposed alternative formula is required, "Conglom" asserts, to take into account the contribution the intangible income makes to "Conglom's" earnings. Taxpayer Exs. 18-20, pp. 4, 7-8 of each exhibit (using Bates stamped page numbers included on each page of each exhibit); Tr. pp. 171-72 ("Gordon").

79. "Conglom" proposes that its fourth factor be given a proposed 80% ceiling and a 20% floor. That is to say, the intangible factor will never be given a weight that is more than 80% of the total factor, even when "Conglom's" described "Passive Income Ratio" is greater than 160% of "Conglom's" total apportionable income, and the intangible factor will not be used at all (and the standard three factor formula will be used) whenever that ratio is less than 40% of "Conglom's" total apportionable income. Taxpayer Exs. 18-20, pp. 7-8 of each exhibit; Tr. pp. 138-43 ("Gordon").

80. When used in its proposed formula, the value of "Conglom's" intangible factor is always equal to 0.0000, since "Conglom" accepts as a given that none of its intellectual properties, that is, the trademarks, patents, copyrights and know-how, the rights to which are the subject of the license agreements between "Conglom" and its licensees, are used in Illinois. Taxpayer Exs. 18-20, p. 9 of each exhibit;[3] Tr. pp 186-87, 205, 260-61 ("Gordon").

81. For 1990, "Conglom's" alternative formula attributes approximately .7% ($^{7}/_{10}^{ths}$ of 1%) of the combined net income earned from its unitary operations within the water's edge of the United States to its activities in Illinois. Taxpayer Ex. 18, p. 9; Tr. p. 154 ("Gordon").

82. For 1991, "Conglom's" preferred formula attributes approximately 1% of its combined net income to its activities in Illinois. Taxpayer Ex. 19, p. 9; Tr. pp. 164-65 ("Gordon").

83. For 1992, "Conglom's" alternative formula attributes approximately .49% ($^{49}/_{100}^{ths}$ of 1%) of its combined net income to its activities in Illinois. Taxpayer Ex. 20, p. 9; Tr. pp. 167-68 ("Gordon").

Facts Regarding "Conglom's" Claim That Its Operations Within The United States Yielded a Net Loss During the Years At Issue

84. More than half of "Conglom's" global net sales, operating profit and identifiable assets are attributable to its operations outside the water's edge of the United States. Department Exs. 112-114, p. 22 (of each annual report).

85. In its annual reports, "Conglom" reports the comparative amounts of net sales, operating profit and identifiable assets attributable to each of four geographic areas of its global business. Department Exs. 112-114, p. 22 (of each annual report). Each of "Conglom's" annual reports also includes financial data for the year of the report as well as data for

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[3] Because the numerator of the intangible property fraction, which measures the value of the intangible property used in Illinois (*see* Taxpayer Ex. 15), will always be zero, the value of the factor will also always equal zero, since zero divided by any number is zero. Taxpayer Exs. 18-20, p. 9 of each exhibit; Tr. pp. 186-87 ("Gordon").

one or two preceding years, depending on the type of information being reported. Department Exs. 112-114, pp. 22-29 of each annual report.

86. Prior to 1991, "Conglom" described the United States as a separate geographic area when reporting net sales, operating profit and identifiable assets data. Department Ex. 112, p. 22. Also prior to 1991, "Conglom" reported the same financial data attributable to its Canadian operations as part of a geographic area titled, “Western Hemisphere.” *Compare id. with* Department Ex. 113, p. 22 & n.(a).

87. In 1991, "Conglom" began to include the both the United and Canada as a single geographic area for purposes of reporting net sales, operating profit and identifiable asset data. Department Ex. 113, p. 22 n.(a). It also renamed as “Latin America” the geographic area that had been called the “Western Hemisphere” geographic area. *Compare id. with* Department Ex. 112, p. 22.

88. In 1990, "Conglom's" operations in the United States yielded net sales of approximately $1,899,200,000 (1.8992 billion dollars), and an operating profit of approximately $208,900,000 (208.9 million dollars). Department Ex. 112, p. 22.

89. In "Conglom's" 1991 annual report, when it recalculated its geographic area data to include in one area its U.S./Canadian operations, "Conglom" reported that those combined operations yielded an operating profit of approximately $217,400,000 (217.4 million dollars) during 1990. Department Ex. 113, p. 22 & n.(a).

90. During 1989, "Conglom's" operations in Canada produced an operating profit of approximately 6.9 million dollars, which equals approximately 3.7% of "Conglom's" combined U.S./Canadian operating profit for 1989, and approximately 1.4% of "Conglom's" total worldwide operating profit for that year. *Compare* Department Ex. 113, p. 22 (1989 operating profit data calculated to show combined U.S./Canadian profit, and total operating profit data) *with* Department Ex. 112, p. 22 (1989 operating profit

data for U.S., and total operating profit data) (187.0 – 180.1 = 6.9), (6.9 ÷ 187.0 ≈ 3.7%), (6.9 ÷ 481.0 ≈ 1.4%).

91. During 1990, "Conglom's" operations in Canada yielded an operating profit of approximately 8.5 million dollars. That amount of profit, in turn, equaled approximately 3.9% of "Conglom's" combined U.S./Canadian operating profit for 1990, and approximately 1.5% of "Conglom's" total worldwide operating profit for that year. *Compare* Department Ex. 113, p. 22 (1990 operating profit data calculated to show combined U.S./Canadian profit, and total operating profit data)[4] *with* Department Ex. 112, p. 22 (1990 operating profit data for U.S., and total operating profit data) (217.4 – 208.9 = 8.5), (8.5 ÷ 217.4 ≈ 3.9%), (8.5 ÷ 554.6 ≈ 1.5%).

92. For 1991, "Conglom's" U.S./Canadian operations reported operating profits of $98,800,000 (98.8 million dollars), after being offset by a $154,000,000 charge taken for restructuring worldwide operations. Department Ex. 113, p. 22 & n.*.[5]

93. If, during 1991, "Conglom's" U.S. and Canadian operating profit percentage ratios remained relatively consistent with those from 1989 and 1990, then the operating profit

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[4] In its 1991 annual report, "Conglom" revised the amount of its 1990 total operating profit as stated in its 1990 annual report, from $584,000,000 (584 million dollars) to 554,600,000 (554.6 million dollars). *Compare* Department Ex. 113, p. 22 *with* Department Ex. 112, p. 22. For purposes of these findings of fact, I am relying on the later statement of "Conglom's" profit as the most correct.

[5] A note to "Conglom's" 1991 and 1992 annual reports' geographic area data stated:

> Operating profit for geographic area and segment data in 1991 includes the effect of the charge for restructured operations of $340.0 [i.e., 340 million dollars]. The effects on geographic area data were to reduce the operating profit of U.S./Canada, Europe, Latin America and Asia/Africa by $154.0, $131.9, 19.4 and $14.4, respectively.

Department Ex. 113, p. 22 n.*; Department Ex. 114, p. 22 n.*. After those charges were taken, the reported operating profits for "Conglom's" U.S./Canada, Europe, Latin America and Asia/Africa geographic areas were, respectively, 98.8, 25.8, 113.4 and 65.2 million dollars. Department Ex. 113, p. 22.

attributable to its Canadian operations would be approximately 3.7 to 3.9 percent of its combined U.S./Canadian operating profit, or approximately 1.4 to 1.5 percent of its total operating profit. *See* Department Exs. 112-113, p. 22.

Assuming the relative consistency of those percentages, the amount of operating profit attributable solely to "Conglom's" Canadian operations for 1991 would be between a range of approximately $3.7 to $3.9 million dollars, or 4.2 to 4.6 million dollars. *See* Department Ex. 113, p. 22 (the amounts representing, respectively, 3.7-3.9% of "Conglom's" combined U.S./Canadian operating profit, and 1.4-1.5% of its total operating profit). That, in turn, would mean that the operating profit attributable solely to "Conglom's" U.S. operations for 1991 would be approximately $94.2 to $95.1 million dollars. *Id*. (98.8 – 4.6 = 94.2), (98.8 – 3.7 = 95.1).

94. For 1992, "Conglom's" U.S./Canadian operations reported operating profits of $324,500,000 (324.5 million dollars), which represented a 13% increase in operating profitability from 1991. Department Exs. 114, pp. 13, 22.

95. If, during 1992, "Conglom's" U.S. and Canadian operating profit percentage ratios remained relatively consistent with those from 1989 and 1990, then the operating profit attributable to its Canadian operations would be approximately 3.7 to 3.9 percent of its combined U.S./Canadian operating profit, or approximately 1.4 to 1.5 percent of its total operating profit. *See* Department Exs. 112-113, p. 22.

Assuming the relative consistency of those percentages, the amount of operating profit attributable solely to "Conglom's" Canadian operations for 1992 would be between a range of approximately 12 to 12.7 million dollars, or 11.1 to 11.9 million dollars. *See* Department Ex. 114, p. 22 (the amounts representing, respectively, 3.7-3.9% of "Conglom's" 1992 combined U.S./Canadian operating profit, and 1.4-1.5% of its total operating profit for 1992). That, in turn, means that the operating profit attributable

solely to "Conglom's" U.S. operations for 1991 was approximately $311.8 to $313.4 million dollars. *Id*. (324.5 – 12.7 = 311.8), (324.5 – 11.1 = 313.4).

96. Most of the increase in "Conglom's" U.S./Canadian area's sales and profits during 1992 were attributable to "Conglom's" operations in the U.S., since Canada was impacted by a recession. Department Ex. 114, p. 13.

Conclusions of Law:

Part 1: The NOD

The prima facie correctness of the Department's determinations was established when the Department introduced the NOD into evidence at hearing, under the certification of the Director. 35 **ILCS** 5/904. Thereafter, the burden shifted to "Conglom" to prove that the Department's determinations that led to the issuance, and later, to the agreed-upon revisions of, the NOD in the matter, were in error. 35 **ILCS** 5/904(a); Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295, 421 N.E.2d 236, 238 (1st Dist. 1981). The burden also lies with a taxpayer whose amended return seeking a refund of tax is denied by the Department. 35 **ILCS** 5/904(a).

Due to the effect of income tax regulation 100.3390(h), and since the only issue at hearing was whether "Conglom" should be allowed to use the alternative apportionment formula as proposed at hearing, "Conglom" introduced no evidence to rebut the prima facie correctness of the Department's NOD, as revised by agreement. Thus, I conclude that "Conglom" has not rebutted the prima facie correctness of the Department's revised determination of the amount of tax due as proposed in the NOD. I recommend, therefore, that the Director finalize the NOD, as revised, pursuant to statute.

Part 2: "Conglom's" Petitions For Alternative Apportionment

A. Burden Of Proof Assigned By § 304(f) Of The IITA

Section 304(f) of the IITA authorizes a taxpayer to petition to use an alternative apportionment method under certain circumstances. 35 **ILCS** 5/304(f). That section provides:

> (f) Alternative allocation. If the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:
>
> (1) Separate accounting;
>
> (2) The exclusion of any one or more factors;
>
> (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
>
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

35 **ILCS** 5/304(f).

The party that wants to use an apportionment formula that differs from the ones set forth in § 304(a)-(c) of the IITA has the burden to show that the statutory method leads to a grossly distorted result. Miami Corp. v. Department of Revenue, 212 Ill. App. 3d 702, 710, 571 N.E.2d 800, 805 (1st Dist. 1991); Lakehead Pipe Line Co., Inc. v. Department of Revenue, 192 Ill. App. 3d 756, 762-63, 549 N.E.2d 598, 602 (1st Dist. 1989). In Lakehead Pipe, the Illinois appellate court relied upon the guidance provided by the predecessor of current regulation § 100.3390(c), because it "… incorporate[d] relevant constitutional considerations in assessing the propriety of an allocation formula …." Lakehead Pipe, 192 Ill. App. 3d at 762-63, 549 N.E.2d at 602.[6] Department income tax regulation § 100.3900(c) provides:

> Burden of Proof. A departure from the required apportionment method is allowed only where such methods do not accurately and fairly reflect business activity in Illinois. An alternative apportionment method may not be invoked, either by the Director or by a taxpayer, merely because it reaches a different apportionment percentage than the required statutory formula. However, if the application of the statutory formula will lead to a grossly distorted result in a particular case, a fair and accurate

[6] Current regulation 100.3390(c) was redrafted from what had been regulation 100.3700(a)(4) (1985). *See* 17 Ill. Reg. 19632 (eff. November 1, 1993). That prior version included substantially the same text as the current version, but interspersed with citations to United States Supreme Court cases. *See* Lakehead Pipeline, 192 Ill. App. 3d at 762-63, 549 N.E.2d at 602 (quoting prior regulation § 3370(a)(4)).

> alternative method is appropriate. The party (the Director or the taxpayer) seeking to utilize an alternative apportionment method has the burden o[f] going forward with the evidence and proving by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State. In addition, the party seeking to use an alternative apportionment formula must go forward with the evidence and prove that the proposed alternative apportionment method fairly and accurately apportions income to Illinois based upon business activity in this State.

86 Ill. Admin. Code § 100.3390(c) (1995).

B. Illinois' Statutory Scheme of Water's Edge Combined Reporting

One useful way to consider different apportionment methods is to think of measuring and cutting a slice of a pie. The pie represents a taxpayer's total net business income that is subject to apportionment. Once the size of the income pie is determined, the apportionment formula is designed to determine how much of that income is roughly attributable to the taxpayer's activities in the taxing state. The resulting "slice" of the taxpayer's pie is the amount of income a state is constitutionally permitted to tax.

Where a taxpayer is a single corporation that conducts a business in several different states, § 304(a) of the IITA requires that the taxpayer first determine the entire net income of the multi-state business. The taxpayer is then required to calculate the amount of its total net income that is attributable to the relative amount of taxpayers' activities in Illinois, by measuring the relative amount of the taxpayer's total property, payroll and sales attributable to its activities in Illinois. Since Illinois double weights its sales factor, the total of the factors would be divided by four to arrive at an average apportionment factor. This factor is then multiplied by the taxpayer's total net income to determine the portion of its total income on which Illinois income tax will be assessed. General Telephone Co. v. Johnson, 103 Ill. 2d 363, 370, 469 N.E.2d 1067, 1070 (1984).

Combined apportionment was developed for use where a corporate taxpayer is a member of a closely associated group of corporations that collectively engages in a multi-state unitary

business. General Telephone Co., 103 Ill. 2d at 371, 469 N.E.2d at 1071; 35 **ILCS** 5/1501(a)(27) (definition of "unitary business group"). The General Telephone court said:

> … When a corporate taxpayer is a member of such a [unitary] group, ordinary section 304(a) formula apportionment — which considers only the property, payroll, sales, and business income of an individual corporation — often does not fairly depict the amount of the unitary business group's income that has resulted from the individual corporate taxpayer's activities within the taxing State. To resolve this problem, combined apportionment employs a formula which is similar to that set out in section 304(a), but which takes into account the property, payroll, sales, and business income of *the entire unitary business group*; that is, all of the corporations of the group. Caterpillar Tractor Co. v. Lenckos (1981), 84 Ill.2d 102, 108-09, 49 Ill. Dec. 329, 417 N.E.2d 1343.

General Telephone, 103 Ill. 2d at 371, 469 N.E.2d at 1071 (emphasis added).

Combined apportionment works in the following manner. First, the business income of each corporate member of the group is computed so that the total business income of the entire group may be ascertained. Then, to determine the apportionment factor for a group member subject to the Illinois income tax (that is to say, for a group member having payroll or property in Illinois), the property, payroll, and sales factors would be computed by using the individual group member's Illinois property, payroll, and sales as numerators, and the entire unitary group's property, payroll, and sales as denominators. The average of these three factors would be the group member's apportionment factor. This apportionment factor is then applied to the group's total business income to derive the amount of net income on which the group member would pay Illinois income tax. General Telephone, 103 Ill. 2d at 371-72, 469 N.E.2d at 1071.

Under Illinois' method of reporting and apportionment, Illinois does not look beyond the water's edge, that is, beyond the geographical boundaries of the United States, in determining what activities are appropriately considered to be the activities of the group. Caterpillar Financial Services Corp. v. McGaw, 288 Ill. App. 3d 389, 392-93, 680 N.E.2d 1082, 1083-84 (3rd Dist. 1997). By statute, the group may only consist of members whose activities are conducted within the water's edge of the United States. 35 **ILCS** 5/1501(a)(27); Caterpillar Financial Services, 288

Ill. App. 3d at 393, 680 N.E.2d at 1084. Thus, a corporation that has 80% or more of its payroll and property in a foreign country cannot be included as a member of the water's edge unitary group. 35 **ILCS** 5/1501(a)(27). Since such corporations cannot be members of a taxpayer's unitary business group, the net income of such corporations is not included in the group's income pie that is subject to apportionment. Caterpillar Financial Services, 288 Ill. App. 3d at 399, 680 N.E.2d at 1088.

Again, what Illinois' method of combined apportionment for unitary groups seeks to apportion is the combined net income of the entire domestic unitary group, some of whose members may conduct business wholly or partially in Illinois, while other members may conduct business wholly outside Illinois. General Telephone, 103 Ill. 2d at 371, 469 N.E.2d at 1071. Under the scheme, certain items or streams of income realized by a group member's regular or integral operations may well be derived from activities conducted wholly outside Illinois — like the royalty income that was derived from "Conglom's" licenses that were drawn, executed and monitored by "Conglom" employees and/or agents who were employed outside Illinois — but within the water's edge of the United States. As a matter of statute, whether any particular item of income is apportionable by Illinois depends on whether or not it is properly classified as business income. *See* 35 **ILCS** 5/1501(a)(1) (definition of business income). Business income is apportionable under the provisions of the IITA, whereas non-business income is allocable to one or more of the states where the income is earned. "Conglom's" chief witness at hearing testified unequivocally that the income at issue is business income. Tr. p. 199 ("Gordon").

C. The Factual Basis For "Conglom's" Claim That Illinois' Three-Factor Apportionment Formula Distorts The Amount Of Its Combined Business Income Attributable To Its Activities In Illinois

"Conglom's" primary factual basis for requesting permission to use an alternative apportionment formula is that, but for its intangible income, its operations within the United

States and within Illinois would be unprofitable. "Conglom's" Brief, p. 11. Specifically, "Conglom" argues that:

> As was the case with "Conglom's" overall domestic operations, "Conglom's" operations in Illinois during the Audit Years resulted in a loss. (Tr. at 149-51, 178-79 ["Gordon"].) That is, "Conglom's" business of manufacturing and distributing goods for sale within the United States resulted in no net income during the audit years. (Tr. at 301 ["Gordon"].)
>
> Although "Conglom's" domestic manufacturing and distribution operations produced a loss, "Conglom" did earn business income during the Audit Years from the licensing of its intangible property. (Tr. at 135, 171-72 ["Gordon"].) In fact, as Mr. "Gordon" fully explained, "Conglom's" apportionable business income for the Audit Years is entirely attributable to dividends and royalties paid by its foreign subsidiaries to "Conglom". ("Conglom" Exs. 28-32; Tr. at 144-45, 221 ["Gordon"].)

"Conglom's" Brief, p. 11 (emphasis original). The evidence "Conglom" cites to support its argument is the testimony of William "Gordon", "Conglom's" assistant director of state tax, and its principle witness at hearing. *Id*.[7]

At hearing and in its response, the Department challenged "Gordon's" testimony and "Conglom's" fundamental assertion by calling attention to statements "Conglom" made in its annual reports regarding the operating profit attributable to its operations within the United States during the years at issue. Tr. pp. 307-10 ("Gordon"); Department of Revenue's Post-Trial Brief in Opposition to Taxpayer's Petitions for Alternative Apportionment ("Department's Brief"), pp. 27-28. The Department argued that the statements made in those regularly kept books and records contradicted "Conglom's" mere assertion that its domestic operations resulted in a net loss during the years at issue. Department's Brief, pp. 27-28. A review of that documentary evidence supports the Department's challenge to "Conglom's" assertion.

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[7] The citation to documentary evidence in the portion of the argument quoted above, i.e., "Conglom" Exs. 28-32, refers to license agreements between "Conglom" and certain royalty paying licensees/subsidiaries. Those documents, however, do not tend to make it more or less likely that "Conglom's" domestic operations were unprofitable during the years at issue.

In its annual reports, "Conglom" broke down and reported the net sales and operating profits for each of four separate geographic areas of its global business for each year at issue. When making these reports, "Conglom" used principles of consolidated reporting, and eliminated, where appropriate, inter-company transactions. Department Exs. 112-114, p. 30 of each annual report. For 1990, "Conglom" reported that its operations in the United States yielded net sales of approximately $1,899,200,000 (1.8992 billion dollars), and an operating profit of approximately $208,900,000 (208.9 million dollars). Department Ex. 112, p. 22. For 1991, the year when "Conglom" combined its Canadian and U.S. operations into a single geographic area, "Conglom" reported that its U.S./Canadian operations yielded net sales of $2,195,900,000 (2.196 billion dollars). Department Ex. 113, p. 22 & n.*. After being offset by a $154,000,000 charge taken for restructuring worldwide operations, "Conglom" reported that its U.S./Canadian area reported operating profits of $98,800,000 (98.8 million dollars). *Id*.

A review of the "Conglom's" 1991 annual report also shows that, for 1990 and 1989, "Conglom's" operations in Canada's equaled approximately 3.7 to 3.9% of "Conglom's" U.S. operating profit, and approximately 1.4 to 1.5% of "Conglom's" total operating profit. Department Exs. 112-113, p. 22 of each annual report. If, during 1991, the output of "Conglom's" Canadian operations remained relatively consistent with its output for each of the prior two years, then for 1991, the same Canadian operations would have produced operating profit in the range of approximately $3.7 to 4.6 million dollars. *See* Department Ex. 113, p. 22 (the amounts representing, respectively, 3.7-3.9% of "Conglom's" combined U.S./Canadian operating profit, and 1.4-1.5% of its total operating profit). That, in turn, would mean that the operating profit attributable solely to "Conglom's" U.S. operations for 1991 would be approximately $94.2 to $95.1 million dollars. *Id*. (98.8 – 4.6 = 94.2), (98.8 – 3.7 = 95.1). Those profit figures, again, are the profits "Conglom" reported *after* taking a $154 million dollar charge against its domestic operations. Department Exs. 113-114, p. 22 & n.* of each report.

In its 1992 report, "Conglom" reported that its U.S./Canadian operations had operating profits of $324,500,000 (324.5 million dollars). Department Exs. 114, p. 22. If, during 1992, the output of "Conglom's" Canadian operations remained relatively consistent with the percentages of 1990 and 1989, then for 1992, "Conglom's" U.S. operations would have produced approximately 331.8 to 313.4 million dollars in operating profit. *See id*. The record, however, shows that "Conglom" attributed most of the increase in "Conglom's" U.S./Canadian area's sales and profits during 1992 to its U.S. operations, since Canada was impacted by a recession. *Id*., p. 13. Thus, for 1992, one may presume that "Conglom's" U.S. operations produced an even greater amount of operating profit.

In its reply, "Conglom" responded to the Department's citation to its annual reports to challenge "Conglom's" assertion that its domestic operations had net losses during the years at issue. It argued:

> It is undeniable that "Conglom" operated at a loss domestically. After all, it is only the foreign royalty income that allowed "Conglom" to have net business income, overall, in the tax years at issue. The unambiguous testimony offered on this point was unrebutted. (See Tr. at 149-51, 178-79, 301 ["Gordon"]).
>
> Having failed to offer any direct evidence, the Department insinuates that, as "Conglom's" annual reports and SEC 10-K filings do not mention the domestic operating loss or the significant contribution to income of royalties from the foreign subsidiaries, then it must not be true. (See Dept. Br. At 27.) But the distinctions between the income and operations of corporate divisions and subsidiaries that are pertinent to state and federal income tax assessment are completely different from those important to shareholders, or to the Securities and Exchange Commission. Moreover, and as the Department very well knows, book income as noted in "Conglom's" annual reports is not the same as taxable income, which reflects many adjustments to book income. The Department is merely grasping at straws.

Post-Hearing Reply Brief in Support of Taxpayer's Petitions for Alternative Apportionment ("Conglom's" Reply), pp. 16-17.

An employee / witnesses' testimony regarding his employer's operations may be rebutted not only by cross-examination or by the contrary testimony of another witness, but also by the books and records of his employer which are inconsistent with the subject of his testimony. Here, "Conglom" has the burden to show, among other things, that Illinois' three factor formula results in an attribution of income that is out of all proportion with its activities in Illinois. Lakehead Pipe, 192 Ill. App. 3d at 762-63, 549 N.E.2d at 602; 86 Ill. Admin. Code § 100.3390(c) (1995). When contesting such determinations before the Department or a court, "Conglom" is obliged to overcome its burden using books and records and, where necessary, with competent testimony that is consistent and clearly identified with such books and records to show that the Department's determinations were incorrect. 35 **ILCS** 5/904(a); *see also,* Branson v. Department of Revenue, 68 Ill. 2d 247, 261, 659 N.E.2d 961, 968 (1995) (statutory presumption of correctness applies to all elements required for the issuance of an assessment). Testimony, even uncontroverted testimony, which is not supported by or closely identified with books and records is not sufficient to rebut the presumptive correctness of the Department's prima facie case. Balla, 96 Ill. App. 3d at 296-97, 421 N.E.2d at 239 (divorced mother's uncontroverted testimony that she financially supported a child for whom she claimed an exemption, but which testimony was not corroborated with documentary evidence (a copy of taxpayer's federal income tax return), was insufficient to show that she was entitled to the exemption denied by the Department); Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill. App. 3d 203, 217, 577 N.E.2d 1278, 1287 (1st Dist. 1991) ("To overcome the Department's prima facie case, a taxpayer must present more than its testimony denying the accuracy of the assessments, but must present sufficient documentary support for its assertions.").

"Conglom's" claim and "Gordon"'s testimony that "Conglom's" domestic operations lost money during the years at issue are, on their face, inconsistent with statements contained in "Conglom's" own audited financial books and records. Department Exs. 112-114, p. 22 of each annual report. In its annual reports, "Conglom" stated unequivocally that its U.S. operations had

operating profits during the years at issue. Those written statements, therefore, constitute out of court statements made by "Conglom" which are inconsistent with its position at hearing. “Generally, any statement made by a party or on his behalf which is inconsistent with his position in litigation may be introduced into evidence against him.” In re County Treasurer, 166 Ill. App. 3d 373, 379, 519 N.E.2d 1010, 1014 (1st Dist. 1988), *aff’d*, 131 Ill. 2d 541 (1989); M. Graham, Cleary & Graham’s Handbook of Illinois Evidence § 802.1 (7th ed. 1999). Thus, contrary to "Conglom's" reply, the statements in "Conglom's" annual reports constitute direct and substantive evidence that "Conglom's" domestic operations were profitable during the years at issue. Security Savings and Loan Assn. v. Commissioner of Savings and Loan Assns., 77 Ill. App. 3d 606, 610, 396 N.E.2d 320, 323 (3d Dist. 1979) (“When they are relevant to, and have a material bearing on, the issues in the case, admissions are ordinarily admissible as original or substantive evidence of the truth of the statements made or of the existence of any facts which they have a tendency to establish.”).

After reviewing the record, I note that, for each of the years at issue, PSI and VCA-NY, two of the corporations having nexus with Illinois, reported losses. Department Ex. 76, pp. 84, 104; Department Ex. 79, pp. 21, 26; Department Ex. 82, pp. 57, 62. But "Conglom", the parent of "Conglom's" Illinois unitary business group, reported federal taxable income that more than made up for the losses of those subsidiaries. Department Ex. 76, pp. 44, 96; Department Ex. 79, p. 20; Department Ex. 82, p. 56. It was "Conglom", moreover, that received the lion’s share of the royalties at issue here. Department Ex. 76, p. 44; Department Ex. 79, p. 20; Department Ex. 82, p. 56. Moreover, since combined reporting seeks to apportion the net business income of an entire unitary group of affiliated corporations (*see* General Telephone, 103 Ill. 2d at 371, 469 N.E.2d at 1071), whether some unitary group members doing business in Illinois may have had losses is not the issue. What matters is whether the group *as a whole* had losses from all of the activities conducted within the water’s edge of the United States.

"Conglom's" Illinois returns also show that "Conglom" had taxable business income during each of the years at issue. Department Ex. 76, pp. 1-2 (Part I, line 7, Part III, lines 4, 11); Department Ex. 79, pp. 1-2 (Part I, line 7, Part III, lines 4, 11); Department Ex. 82, pp. 1-2 (Part I, line 7, Part III, lines 4, 11). To be sure, the amount of "base income allocable to Illinois", as reported by "Conglom" on those returns, is less than the gross royalties "Conglom" received during the years at issue. *Compare* Department Ex. 76, p. 2 (Part III, lines 4, 7); Department Ex. 79, p. 2 (Part III, lines 4, 11), Department Ex. 82, p. 2 (Part III, lines 4, 11) *with* Taxpayer Exs. 1-3 (line 7 of each federal return). But that does not mean that all of "Conglom's" Illinois base income was attributable only (or even largely) to the income "Conglom" received in the form of royalty and dividend payments from its foreign subsidiaries.

For that proposition to be true, one would have to accept that none of "Conglom's" deductions from income (listed on lines 12 to 29 of "Conglom's" federal returns) were attributable to "Conglom's" use of its trademarks, patents, know-how, etc., the license of which produced the gross royalties reported on line 7 of its federal returns. "Gordon" himself testified that one must match up expenses to income when calculating the amount of income subject to taxation. Tr. pp. 209-10 ("Gordon"). Yet "Gordon"'s conclusion that "Conglom's" gross royalties and dividend income constitutes most if not all of "Conglom's" taxable income is clearly premised on his mere comparison of lines 4 and 7 (respectively, dividends and gross royalties) with line 28 (taxable income before NOL and special deductions) of "Conglom's" consolidated federal return (Tr. p. 310 ("Gordon")), without taking into account any of the expenses "Conglom" incurred, domestically, to produce such income. *See* Taxpayer Ex. 33 (Department's responses to "Conglom's" Requests to Admit Facts), pp. 2, 7, 11 (respectively, request and response nos. 3, 13, 23).

One item of expense directly related to "Conglom's" use of its trademarks within the United States is "Conglom's" advertising expense. During the years at issue, advertising was one of the only costs associated with a taxpayer's use of trademarks that was currently deductible, that

is, advertising expenses were deductible in the year expended. Peter F. Riley & Saikrishna B. Prakash, General United States Tax Considerations Pertaining To The Creation, Acquisition And Disposition Of Trademarks ("Tax Consequences of Trademarks"), 438 PLI/Pat 403, 411-12 (PLI Order No. G4-3965) (April 15, 1996) ("Costs associated with advertising the trademark generally are deductible. Advertising costs incurred in connection with a taxpayer's trade or business generally are currently deductible as ordinary and necessary business expenses. Code § 162; Treas. Reg. § 1.162-1(a). Although advertising does much to "develop" a trademark, advertising costs generally are deductible under Code section 162 as ordinary and necessary business expenses unlike other costs or expenses incurred in connection with the design or development a trademark."). During each year at issue, "Conglom's" advertising expenses exceeded its gross royalties. Taxpayer Exs. 1-3 (lines 7, 23 of each federal return).

There were also costs associated with registering trademarks and/or patents within the United States, as well as costs associated with "Conglom's" other intangible assets. Tr. p. 612. Those costs, however, were not currently deductible (and remain so, at least for self-created trademarks, *see* 26 U.S.C. § 197 (1993)), and were instead required to be capitalized over the life of the intangible asset. For accounting purposes, those capitalized costs are then amortized. Newark Morning Ledger Co v. U.S., 507 U.S. 546, 571 n.1, 113 S.Ct. 1670 n.1, 1683, 123 L.Ed.2d 288 (1993) ("… intangible assets are amortized, while tangible assets are depreciated", *citing* Black's Law Dictionary 83, 441 (6th ed. 1990); Gregorcich, Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill, 28 Tax Law. 251, 253 (1975) ("Amortization is the commonly accepted way of referring to depreciation of intangible property")) (J.Suter, dissenting). "Conglom", in fact, amortized the capitalized costs associated with its intangible properties during each of the years at issue. Department Exs. 112-114, pp. 27, 30 of each annual report.

"Conglom's" advertising and other expenses show that "Conglom" had domestic costs that were directly related to its regular and ordinary use of its trademarks and other intangible

properties. *See* Taxpayer Exs. 1-2, line 23 of each return; Department Exs. 112-114, p. 30 of each report. Those expenses also tend to prove, if further proof is necessary, that "Conglom" used its trademarks within the water's edge of the United States. One of the ways it enjoyed the use of those properties within the water's edge was by registering its new and maintaining its existing trademarks with the United States Patent and Trademark Office. Tr. p. 481. Another way it used such properties was to draft and execute licenses of its trademarks and other intellectual properties to its wholly owned foreign subsidiaries and to others for use outside the United States. Tr. pp. 480-82. It also continued to monitor its licensees' usage, and to direct, from within the United States, the licensees' actions regarding the licensed intangible properties. Tr. pp. 463-64, 475-77, 480-83, 579-80.

Now, there is no doubt that "Conglom's" licensees earned income by using such properties outside the United States, and that, thereafter, the licensees used a percentage of that income to make royalty and dividend payments to "Conglom". But that does not mean that "Conglom" earned such income because of activities *it* conducted outside the United States. The income producing activities related to the royalty income at issue include the drafting, approval and execution of its licenses, and the regular monitoring and supervision "Conglom" agreed to provide while such agreements were in place. *See, e.g.* Tr. pp. 462-64, 468-72, 475-77, 480-83, 486-87, 494-95, 571, 579-80, 583-88, 591-600. Those activities occurred in the regular and ordinary course of "Conglom's" business, and took place inside the water's edge of the United States. Tr. pp. 462, 558. The income producing activities related to the dividend payments "Conglom" received from its foreign subsidiaries also occurred in ordinary course of "Conglom's" exercise of successful management control and influence over its foreign subsidiaries, as part of its worldwide unitary business. *See* Department Ex. 90; Tr. pp. 199, 259-60 ("Gordon").

As to the reasons expressed in "Conglom's" reply, I acknowledge that there is a difference between financial accounting and tax accounting (*see* Thor Power Tool Co. v. Commissioner of Internal Revenue, 439 U.S. 522, 542, 99 S.Ct. 773, 786, 58 L.Ed.2d 785

(1979)), and that "… the characterization of a transaction for financial reporting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same." *Id*. at 541, 99 S.Ct. at 785 (*quoting* Frank Lyon Co. v. United States, 435 U.S. 561, 577, 98 S.Ct. 1291, 1300, 55 L.Ed.2d 550 (1978)). But many commentators, as well as the United States Supreme Court, have acknowledged that "financial accounting has as its foundation the principle of conservatism, with its corollary that possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." Thor, 439 U.S. at 542-43, 99 S.Ct. at 786-87 & n.18 (*citing* AICPA Accounting Principles Board, Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, ¶ 171 (1970), reprinted in 2 APB Accounting Principles 9089 (1973); Sterling, Conservatism: The Fundamental Principle of Valuation in Traditional Accounting, 3 Abacus 109-113 (1967)).

If one assumes that when "Conglom" prepared its annual reports, it was following conservative financial accounting principles and erring on the side of understating the operating profit attributable to its domestic operations, any weight to be given "Gordon"'s testimony that, for tax reporting purposes, "Conglom's" domestic operations really lost money simply has to depend on whether "Conglom" was able to offer some valid — and documented — explanation for the difference between "Conglom's" audited financial statements and "Gordon"'s testimony. No such documented explanation, however, was offered at hearing. Illinois law, moreover, is relatively clear that intangible income in the form of royalty, interest and other payments from foreign subsidiaries are to be treated like income from a taxpayer's sales to domestic customers. Caterpillar Financial Services, 288 Ill. App. 3d at 400, 680 N.E.2d at 1088.

Here, "Conglom's" annual reports are the clearest and most definite documentary ("books and records") evidence admitted that is probative of the question whether "Conglom's" domestic activities were profitable or unprofitable during the years at issue, an issue clearly disputed by the parties (*compare* "Conglom's" Brief, p. 11 *and* Reply, pp. 16-17 *with* Department's Response, pp. 27-28), and those reports reflect that "Conglom's" water's edge operations made money.

Department Exs. 112-114. "Conglom's" annual reports corroborate other aspects of "Gordon"'s testimony regarding "Conglom's" activities during the years at issue. For example, "Gordon" testified that "Conglom's" foreign operations were more profitable than its domestic operations, and "Conglom's" annual reports agree. For each of the years at issue, the annual reports show that "Conglom's" domestic operating profit was only 30% to 40% of "Conglom's" total worldwide operating profit. Department Exs. 112-114, p. 22 of each annual report. "Conglom's" Form 10-K also corroborates "Gordon"'s testimony that "Conglom's" trademarks were the most important type of intangible property licensed to its foreign subsidiaries. Tr. p. 205 ("Gordon"); Department Ex. 117, p. 2 (Bates stamp page no. CP06813). But "Conglom's" annual reports are absolutely inconsistent with "Gordon"'s testimony regarding "Conglom's" domestic profitability. Department Exs. 112-114, p. 22 of each annual report. Thus, I will not accept "Gordon"'s mere conclusory testimony or his employer's mere argument that, but for the royalty and dividend income at issue, "Conglom's" domestic operations were unprofitable during the years at issue. Balla, 96 Ill. App. 3d at 296, 421 N.E.2d at 238-39 (recounting the circuit court's characterization of taxpayer's testimony as being insufficient to rebut the presumptive correctness of the Department's determination that taxpayer was not entitled to the exemptions sought); *see also*, A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 833-34, 527 N.E.2d 1048, 1053 (1st Dist. 1988) ("A taxpayer cannot overcome the DOR's prima facie case merely by denying the accuracy of its assessments. Instead, evidence must be presented which is consistent, probable, and identified with its books and records.").

D. Whether Illinois' Three-Factor Formula Distorts the Amount of "Conglom's" Combined Net Income That Is Attributable to "Conglom's" Activities in Illinois

"Conglom" asserts that Illinois' statutory three factor formula fails to take into account its royalty and dividend income. When considering whether Illinois' statutory three factor formula takes into account the expenses traditionally associated with the production of a taxpayer's income, it is important to recall just what it is that each different factor purports to measure.

Briefly, the property and payroll factors measure where a taxpayer's "… offices, plants, machinery, warehouses, inventory, and employees [are] located …." I J. Hellerstein & W. Hellerstein, State Taxation ("Hellerstein, State Taxation") ¶ 8.06[1]; 35 **ILCS** 304(a)(1)-(2). The Hellersteins say that the property and payroll factors:

> … reflect the geographic "source" of the taxpayer's income, which may reasonably be attributed to the locus of the taxpayer's property and employees. On the other hand, they constitute rough indicia of the protection, benefits, and services that the state furnishes to the enterprise and of the costs embrace such items as highways, streets, police and fire protection, as well as services furnished the employees of the business, through schools recreational facilities, health care, and welfare benefits. There is also increasing awareness of the importance to business, and the heavy costs to governments, of providing a livable physical environment, through clean air, potable water, adequate sewage disposal, reduction of noise pollution, and an overall ambience in which to participate in or enjoy leisure and cultural activities.

Hellerstein, State Taxation ¶ 8.06[1].

The Department's regulation interpreting and administering § 304(a)(1)'s property factor is set forth at 86 Ill. Admin. Code § 100.3350. That regulation provides, in part:

> (a) In general. **The property factor of the apportionment formula for each trade or business of a person shall include all real and tangible personal property owned or rented by such person and used during the tax period in the regular course of such trade or business. The term "real and tangible personal property" includes land, building, machinery, stocks of goods, equipment, and other real and tangible personal property but does not include coin or currency**. Property used in connection with the production of non-business income shall be excluded from the property factor. Property used both in the regular course of a person's trade or business and in the production of non-business income shall be included in the factor only to the extent the property is used in the regular course of the person's trade or business. The method of determining that portion of the value to be included in the factor will depend on the facts of each case. The property factor shall include the average value of property includable in the factor. See subsection (g), below.
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> * * * *

86 Ill. Admin. Code § 100.3350(a) (emphasis added).

The Department's regulation interpreting and administering § 304(a)(2)'s payroll factor is set forth at 86 Ill. Admin. Code § 100.3360. That regulation provides, in part:

> The payroll factor of the apportionment formula for each trade or business of an employer shall include the total amount paid by the employer in the regular course of its trade or business for compensation during the tax period.

86 Ill. Admin. Code § 100.3360(a).

The sales factor:

> … is designed to give weight in the apportionment to the states in which the taxpayer markets its goods. [footnotes omitted] The sales factor — with the sales destination test — is justified as much by political as by economic considerations. The economic justification for the other two factors — payroll and property — is clear enough. "Income," we were told long ago, "may be defined as the gain derived from capital, from labor, or from both combined." While this definition is no longer viewed as a constitutional imperative, income in fact is largely generated by capital and labor, and the property and payroll factors reflect these essential income producing elements. The sales factor, by contrast, attributes income to states in which goods are consumed and serves as a counterbalance to the property and payroll factors which tend to attribute income to states in which goods are produced.

Hellerstein, State Taxation ¶ 8.06[2].

The Department's regulation interpreting and administering § 304(a)(3)'s sales factor is set forth at 86 Ill. Admin. Code § 100.3370. That regulation provides, in part:

> a) In general.
>
> 1) IITA Section 1501 (a)(22) defines the term "sales" to mean all gross receipts of the person not allocated under IITA Sections 301, 302 and 303. Thus, for the purposes of the sales factor of the apportionment formula for each trade or business of the person, the term "sales" means all gross receipts derived by the person from transactions and activity in the regular course of such trade or business. **The following are rules for determining "sales" in various situations:**
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> * * *
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> E) **In the case of a person engaged in the sale, assignment, or licensing of intangible personal property such as patents and copyrights, "sales" includes the gross receipts therefrom.**
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> * * *

> b) Denominator. The denominator of the sales factor shall include the total gross receipts derived by the person from transactions and activity in the regular course of its trade or business, except receipts excluded under 86 Ill. Adm. Code 100.3380(b).
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> * * *
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> 3) Sales other than sales of tangible personal property in this State. The sales factor includes gross receipts from transactions other than sales of tangible personal property (including transactions with the United States Government); gross receipts are attributed to this State if the income producing activity which gave rise to the receipts is performed wholly within this State. Also, gross receipts are attributed to this State if, with respect to a particular item of income, the income producing activity is performed in this State, based on costs of performance.
>
> A) Income producing activity defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor. **The mere holding of intangible personal property is not, of itself, an income producing activity. Accordingly, the income producing activity includes but is not limited to the following:**
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> * * *
>
> **iv) The sale, licensing or other use of intangible personal property.**
>
> B) Costs of performance defined. The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the person.
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> * * *

86 Ill. Admin Code § 100.3370(a)-(b) (emphasis added).

There is nothing unusual about the Department's interpretations of the statutory factors designated by § 304(a) of the IITA, or of the types of expenses that should be taken into account within those Illinois apportionment factors. All of the Illinois income tax regulations quoted here are virtually identical to regulations promulgated by the Multistate Tax Commission when interpreting the Uniform Division of Income for Tax Purposes Act (UDITPA), upon which the IITA was derived. *See* Texaco-Cities Service Pipeline Co. v. McGaw, 182 Ill. 2d 262, 268, 695

N.E.2d 481, 485 (1998); Multistate Tax Commission, Reg. IV.10.(a) (Property Factor: In General), IV.13.(a) (Payroll Factor: In General), IV.15-.17 (various sales factor regulations).[8]

1. "Conglom's" Water's-Edge Expenses and Costs of Performance Related To The Intangible Income Are Taken Into Account By Illinois' Three Factor Formula

Illinois' statutory formula takes into account "Conglom's" water's edge expenses related to the acquisition, management and disposition, via license, of the intellectual properties and other activities which led to the production of the income at issue here. Specifically, Illinois' payroll factor takes into account the contribution "Conglom's" patent and trademark employees and departments located in New York made to the income at issue, by, *inter alia*, drafting original and/or renewing existing licenses, by monitoring executory licenses, and by advising the licensees regarding the course of action to take should an infringement occur overseas (*see* Tr. pp. 462-64, 472, 555-56, 562, 576-78, 582-83, 590-600), by allocating the compensation paid to such non-Illinois personnel within the denominator of the apportionment fraction. 86 Ill. Admin. Code § 100.3360(a)-(b). Similarly, the payroll factor takes into account the income producing activities of "Conglom's" New Jersey research and development employees and professionals regarding the intellectual properties that are the subject of the licenses at issue, by placing the amount of their compensation within the denominator of the apportionment fraction. *Id*. Further, the payroll factor takes into account the income producing activities "Conglom's" officers and directors made regarding the royalty and dividend income by placing the amounts of their compensation within the denominator of the apportionment fraction. *See* Department Exs. 39-41; 86 Ill. Admin. Code § 100.3360.

Similarly, the contributions "Conglom's" research and development facility in "Someplace", New Jersey, and its manufacturing and other facilities within the water's edge of the United States made to the production of income from "Conglom's" acquisition (either by

[8] The Multistate Tax Commission's regulations are accessible at http://www.mtc.gov/.

creation or purchase), management and disposition of the know-how and intellectual properties that are the subject of the licenses are taken into account within Illinois' property factor by placing the value of those facilities within the denominator of "Conglom's" property factor fraction. 86 Ill. Admin. Code § 100.3350. The property factor, however, is not and was never intended to be weighted differently based on the nature of the goods, services or intangibles that are produced or developed by the employees working at such properties, in the regular course of business. *See id*.

Finally, Illinois' sales factor takes into account "Conglom's" costs of performing the work that produced the gross receipts it realized from licensing its intellectual properties, by placing the net receipts from such sales within the denominator of the sales factor fraction. *See* 86 Ill. Admin. Code § 100.3380(b)(4). In the same manner, the sales factor takes into account the fact that "Conglom's" costs of issuing or acquiring (as the case may have been) and holding the stock of its subsidiaries in order to control their operations as part of its world-wide unitary business did not occur in Illinois, by placing the net receipts from such sales within the denominator of the sales factor fraction. *See id*.; 86 Ill. Admin. Code § 100.3310(d)(5)(E). Regarding the royalty income in particular, the sales factor was specifically designed to take into account where the costs of performance related to a taxpayer's licensing or other disposition of business intangibles occurred, in order to apportion the receipts realized by such activities in the ordinary course of the taxpayer's business. 35 **ILCS** 5/304(a)(3), 5/1501(21); 86 Ill. Admin. Code § 100.3370(a), (b).

Even "Conglom" attributes its success at selling consumer products to its well-known brand names, its quickly repeated efficient production methods and its world-wide knowledge of local markets. Department Ex. 112-114, p. 22 of each annual report. "Conglom" uses its trademarks within the water's edge of the United States, within Illinois, and all over the world in order to make sales of its consumer and other products, and not as a separate and distinct business that is unrelated to its operations within the United States and within Illinois. *E.g.*, Department Ex. 112-114, p. 22 of each annual report; Tr. pp. 125-26, 315-16 ("Gordon"), 343 ("Hearst"), 547-

48 (Thompson); *see also, e.g.*, Taxpayer Ex. 28, pp. 24-25. Thus, each part of Illinois' statutory three factor formula takes into account the ordinary income producing activities and expenses related to "Conglom's" production of the income at issue, as well as the fact that the income producing activities related to the particular income at issue were not performed within Illinois.

2. The Royalty And Dividend Income Is Not Passive Income That Is Wholly Unrelated To "Conglom's" Activities Within The Water's Edge Of The United States, And Within Illinois

At hearing, "Conglom's" opinion witness, Professor "McGinty", testified that the royalty and dividend income that "Conglom" claims requires alternate apportionment was passive income. Tr. pp. 653, 655, 659 (McGuire). "McGinty" also opined that Illinois' statutory formula did not fairly and reasonably apportion "Conglom's" income because "… the income earned by "Conglom" during the audit years was, in large part, very great part, generated by the licensing of trademarks and patents with foreign subsidiaries." Tr. p. 655 ("McGinty").[9] She concluded that such income "… was passive income, not generated by the manufacture and sale of products domestically." *Id*. "McGinty" also testified that, in her opinion, "Conglom's" four-factor formula would fairly apportion "Conglom's" taxable income to Illinois because "… the intangible property owned by the corporation is what generates that — the passive income, which is during these tax years, comprise the vast majority of the taxable income of the company." Tr. p. 657.

For state tax purposes, however, the term "passive income" is generally used to describe income that constitutes non-business income, income which is derived from a discrete business activity that has nothing whatever to do with the taxpayer's activities within the taxing state, or

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9 "McGinty" concluded that an alternative formula was necessary to fairly apportion "Conglom's" intangible income after she was told by "Gordon" that ""Conglom"[ ] earned no taxable business income in Illinois [during] tax years 1990, 1991, and 1992 from its domestic manufacturing and sales operations" and that ""Conglom"['s] … taxable income, taxable business income , [was] derived from its receipt of dividends and royalties from its various foreign subsidiaries." Tr. p. 650 ("McGinty"). The record is clear, however, that the professor made no independent assessment or critical investigation of those facts (Tr. pp. 649-50, 664 ("McGinty")), she just accepted that they were true.

income which was derived from activities serving no operational purpose of the business. *See* Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 788-89, 112 S.Ct. 2251, 2263-64, 119 L.Ed.2d 533 (1992); ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307, 327-28, 102 S.Ct. 3103, 3114-15, 73 L.Ed.2d 787 (1982); Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425, 442, 100 S.Ct. 1223, 1234, 63 L.Ed.2d 510 (1980). The income at issue here fits none of those definitions, and cannot be considered passive income.

Here, the royalty and dividend income was not derived from activities that were a discrete or unrelated part of "Conglom's" unitary business. The facts are that "Conglom" regularly licensed its trademarks and other intellectual properties to its unitary subsidiaries that operated overseas, and to others, and that the subject of those licenses, the intellectual properties themselves, were an integral and invaluable aspect of its regular business operations of manufacturing and marketing consumers products worldwide. *E.g.*, Taxpayer Ex. 28; Department Exs. 112-114 (annual reports). "McGinty" is absolutely right when she concludes that the "[royalty] … income [was] not generated by the manufacture and sale of products domestically." But what makes the income apportionable business income is the fact that it was derived from assets which "Conglom" created, acquired, managed and regularly used to help it and its subsidiaries generate sales of goods throughout the world, including sales within the water's edge of the U.S., and within Illinois. 35 **ILCS** 5/1501(a)(1) (business income "… includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."). All of the intellectual properties transferred by license were created or acquired and managed by "Conglom", and the management, use and disposition (in this case, by license) of those properties were an integral part of its worldwide unitary business. *E.g.*, Department Ex. 116, p. 2. "The use of a capital asset in the taxpayer's regular trade or business indisputably renders that asset an integral part of the taxpayer's regular business operations." Texaco-Cities, 182 Ill. 2d at 272, 695

N.E.2d at 486. Most importantly, much of "Conglom's" success in selling its products is attributable to "Conglom's" productive use of its trademarks. Department Exs. 112-114, p. 22 of each annual report.

Finally, Professor "McGinty" testified that "Conglom's" alternative apportionment formula was needed because "… the intangible property contributes to the generation of one type of income whereas the tangible property [which is what the property factor is designed to take into account] contributes to the generation of another type of income." Tr. p. 654 ("McGinty"). But under the IITA, the only "types" of income that matter are business and non-business income. Business income is apportionable; non-business income is not. Texaco-Cities Service Pipeline Co. v. McGaw, 182 Ill. 2d 262, 268, 695 N.E.2d 481, 484 (1998); Rockwood Holding Co. v. Department of Revenue, 312 Ill.App.3d 1120, 1124 & n.5, 728 N.E.2d 519, 524 (1st Dist. 2000). Here, "Conglom" never asserted that the income was non-business income, either on its returns, in its protests to the NOD, or in any of its petitions for alternative apportionment, and the architect of its alternative formula specifically acknowledged that the income was business income. Tr. p. 199 ("Gordon").

3. Application of Illinois' Three Factor Formula Causes No Gross Distortion, As Construed By The United States Supreme Court, Or By Illinois Cases Applying § 304(f)

As a matter of constitutional law, a state may apportion income earned by a non-resident corporation's activities conducted outside its borders if, for example, the transaction that produced the income served an operational function related to the activities of a unitary business, part of which is conducted within the taxing state. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 784-85, 112 S.Ct. 2251, 119 L.Ed.2d 533 (1992). A state may also constitutionally tax a fairly apportioned share of income earned by a non-domiciliary corporation that was received in the form of payments from other members of the taxpayer's unitary business. ASARCO, 458 U.S. at 329 n.24, 102 S.Ct. at 3116 n.24, 73 L.Ed.2d 787. Here, there is no dispute — nor, given "Conglom's" books and records, could there be any dispute — that

"Conglom's" licensing and/or use of its trademarks, patents and know-how served an operational function that was related to it domestic unitary operations, some of which were conducted within Illinois. *E.g.*, Taxpayer Ex. 28, pp. 24-25 (recitals clauses); Department Ex. 112, p. 22 ("Product quality, brand recognition and acceptance, and marketing capability largely determine success in the Company's business segments"). What is equally undisputed is the fact that the royalty and dividend income at issue was received by "Conglom" in the form of payments from persons who were unitary with "Conglom", even though such persons were not part of "Conglom's" Illinois unitary business group. Department Ex. 90; Tr. p. 199 ("Gordon"). Thus, there is simply no way for "Conglom" to support its argument that, by including the royalty and dividend income in "Conglom's" domestic income pie, Illinois' statutory scheme creates an unconstitutional distortion of the level of "Conglom's" business activities being conducted in Illinois. *See* Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425, 437, 100 S.Ct. 1223, 1231, 63 L.Ed.2d 510 (1980) ("the fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction.") (*quoting* Wisconsin v. J. C. Penney Co., 311 U.S. 435, 444-45, 61 S.Ct. 246, 250, 85 L.Ed. 1143 (1940)).

That conclusion is also warranted by a review of Illinois cases involving a taxpayer's request to invoke an alternative apportionment scheme pursuant to § 304(f) of the IITA. For example, in Miami Corp. v. Department of Revenue, which "Conglom" quotes in support of its petition to use an alternative formula (*see* "Conglom's" brief, pp. 23-25), the Illinois appellate court affirmed the circuit court's decision that Illinois three-factor formula, as applied by the Department in that case, grossly distorted the amount of income to be apportioned to Illinois. Miami Corp. v. Department of Revenue, 212 Ill. App. 3d 702, 571 N.E.2d 800 (1st Dist. 1991). "Conglom" particularly relies upon one part of the decision in which the court wrote:

> While we acknowledge that the increase of plaintiff's liability from approximately $719,000 to more than $2.4 million does not necessarily prove malapportionment (see Citizens

> Utilities Co. v. Department of Revenue (1986), 111 Ill.2d 32, 94 Ill.Dec. 737, 488 N.E.2d 984), we find that the distortion created by the use of the formula amounts to an unfair representation of plaintiff's activities with the State.
>
> The property factor in the formula was designed to measure the average value of real and tangible property, whether owned or rented, used in the taxpayer's business. Property which is owned is valued at its original cost. Rented property is valued at 8 times the net annual rental rate. (Ill.Rev.Stat.1983, ch. 120, par. 3-304(a)(1)(A).) However, the oil and gas reserves in Louisiana which generated in excess of 80% of plaintiff's income is not reflected in the formula because these elements are intangibles.

Miami Corp., 212 Ill. App. 3d at 708, 571 N.E.2d at 804.

The facts of that case, however, are distinguishable from the facts presented here, and distinguishable in a way that warrants a different result. The primary difference is the fact that the intangible income at issue in Miami Corp. arose from the taxpayer's ownership of real estate situated in other states (i.e., royalties from oil and gas rights to taxpayer's land in Louisiana, and royalties from timber rights to taxpayer's land in Florida and Oregon), and the fact that Miami Corp. had no such intangible property rights regarding land owned in Illinois. Both the appellate and the trial court in Miami Corp. relied to a great degree on the reasoning of the Alaska supreme court in Atlantic Richfield v. Alaska, 705 P.2d 418 (Alaska 1985), *app. dism'd*, 474 U.S. 1043, 106 S.Ct. 74, 88 L.Ed.2d 754 (1985). Miami Corp., 212 Ill. App. 3d at 708-09, 571 N.E.2d at 804, 805-06. Specifically, the Alaska supreme court wrote that:

> A unique characteristic of unitary oil and gas businesses is that the major income-producing element is the value of the oil and gas reserves in the ground. While this element can be readily identified, it is not recognized under traditional formula apportionment methods. * * *.
>
> * * *
>
> * * * [S]eparate accounting, not formula apportionment, is the prevailing method throughout the United States for reporting income for oil production."

Atlantic Richfield Co., 705 P.2d at 418, 426. It should be recalled when reading Atlantic Richfield, however, that the taxpayers in that case were asking the court to find unconstitutional Alaska's 1978 change in scheme of income taxation from a UDIPTA formulary apportionment to

separate accounting for taxpayers whose business included oil and gas exploration and production. *Id*., 705 P.2d at 421-25. In other words, taxpayers there were not granted the right to use an alternative method of apportionment, they were being required to use the statutory method.

Here, moreover, there is no failure of Illinois' apportionment formula to recognize the elements that gave rise to the royalty and dividend income, because the intangibles at issue here are not like the intangible rights that ran with the land in Miami Corp. That is to say, the stock of "Conglom's" subsidiaries and intellectual properties do not reflect values that are inextricably tied to real property, yet not reflected in the property factor. Rather, most of the intangible income in this case was derived from "Conglom's" ownership and regular business use of trademarks, which "Conglom" also uses in Illinois when marketing and selling its goods and services. Taxpayer Ex. 33, pp. 2-3, 6-7, 11 (respectively, response & request nos. 2-3, 12-13, 22-23); Tr. pp. 294-95 ("Gordon").

D. Whether "Conglom's" Alternative Formula Fairly And Accurately Reflects Its Business Activities In Illinois

1. "Conglom's" Method of Weighting the Four Factors Included in its Proposed Formula

During the years at issue, Illinois' statutory apportionment formula assigned a weight of 25% to each of the payroll and property factors, and a 50% weight to the sales factor. Thus, the statutory formula attributes comparatively more to the fact that a business is making sales in or from Illinois than it does to the fact that the goods or services being sold are manufactured, assembled and attributable to persons who work in Illinois. That is both rational and constitutional, in that Illinois is providing a hospitable market of consumers and other businesses who are ready and willing to purchase goods and services from the different members of "Conglom's" unitary group that do business here — it is, in fact, providing something in exchange for imposing upon "Conglom" the obligation to pay tax on an fairly apportioned share of its combined net income from all of the different aspects of its domestic unitary business. Wisconsin

v. J. C. Penney Co., 311 U.S. at 444, 61 S.Ct. at 249 ("The simple but controlling question is whether the state has given anything for which it can ask return.").

For the years at issue, "Conglom" assigns its intangible factor a proportional weight of, respectively, 72%, 59% and 80% of the total sum of all of the factors in its apportionment formula. The major effect of "Conglom's" method of weighting its intangible factor is that it significantly reduces the effect "Conglom's" water's edge employees and its manufacturing, office and/or warehouse facilities (i.e., "Conglom's" property, payroll and sales) had on the creation and use of the intellectual properties that were licensed. It was "Conglom's" water's edge personnel who drafted and monitored those licenses (*see* Tr. pp. 528-30), and its water's edge employees, officers and directors who decided that licensing such intangible properties was the appropriate means of receiving value from (as well as providing value to) the persons to whom "Conglom" granted the right to use such properties.

So here, "Conglom" did not earn the income at issue by being a passive investor who merely held title to certain trademarks, patents, know-how and the stock of unrelated corporations. *See* 86 Ill. Admin. Code § 100.3010(d)(5)(F). Rather, it received value in the form of royalties by licensing its trademarks, patents and know-how as a way of managing its world wide business, and it also received value in the form of dividends paid by its subsidiaries as a result of "Conglom's" successful management of those corporations. Borden, Inc. v. Department of Revenue, 295 Ill. App. 3d 1001, 1011, 692 N.E.2d 1335, 1342 (1st Dist 1998) (capital gain from taxpayer's sale of stock of its unitary subsidiaries was apportionable business income); 86 Ill. Admin. Code §§ 100.3010(d)(5)(C), (E); 100.3370. And regardless of how "Conglom" granted its domestic subsidiaries the right to use "Conglom's" trademarks and other intellectual properties (the record is devoid of any evidence on the point) when manufacturing, distributing, marketing and actually selling the various goods and services in "Conglom's" broad product lines in the United States, there can be no doubt that such properties were, in fact, used. "Conglom's" formula, however, attributes the production of its royalty and dividend income almost wholly to

the intellectual properties that were previously created or acquired by "Conglom" in the regular course of its business operations, while ignoring the fact that the very existence and intrinsic value of many of those assets is attributable to the efforts of its domestic officers, directors and employees, and to the facilities where such persons operate within the water's edge of the United States.

2. "Conglom's" Intangible Property Factor Purports To, But Does Not, Compare The Value Of "Conglom's" Intangible Properties Used in Illinois Versus The Value Of "Conglom's" Intangible Properties Used Everywhere Worldwide

"Conglom's" formula also attempts to allocate the business income earned from "Conglom's" licensing of intangible assets that are integral to its regular business operations with a factor that purports to measure where "Conglom's" intangible properties are used by "Conglom's" licensees — but while ignoring where such properties are used by "Conglom", the licensor. "Conglom's" fourth factor purports to take the source of such income into account by comparing the amount of "Conglom's" intellectual properties that are used in Illinois versus the amount of such properties used everywhere around the world. Taxpayer Ex. 14. "Conglom", however, never actually assigns any numerical value to either the numerator or denominator of its intangible property factor, even though, in each of its annual reports' consolidated balance sheet, "Conglom" reports the net value of its intangible assets.[10] Department Exs. 112-114, p. 27 of each report.

When asking that its formula be implemented, moreover, "Conglom" does not identify which of its intellectual properties were used in Illinois, or what the total value of such assets may have been during the years at issue. Instead, "Conglom's" intangible property factor assumes that

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[10] The value of "Conglom's" intangible assets themselves, moreover, is distinct from the value of "Conglom's" licenses of such intangible assets to its foreign subsidiaries. One estimate of the latter value is easily ascertained — it is the amount of gross royalties as reported on "Conglom's" federal returns. Taxpayer Exs. 1-3, line 7 of each federal return. There was no explanation, at hearing, why "Conglom" did not use its own valuation of its intangible properties in its intangible factor. *See* Department Exs. 112-114, p. 27 of each annual report.

none of its intellectual properties were used in Illinois because "Gordon" determined that an item of licensed intangible property is used in the location where the licensee of such property did business. Tr. pp. 260-61, 263-64 ("Gordon").

Further, both "Gordon" and "McGinty" testified that it didn't matter what value might be placed on "Conglom's" intellectual properties, since none of the licensees did business in Illinois, and therefore, none of them could have used any of the licensed intangibles in Illinois. Tr. pp. 186-87 ("Gordon"), 666 ("McGinty"). "McGinty", however, conceded that she didn't know how to ascertain which state's numerator would properly include "Conglom's" royalty income and dividend income. Tr. p. 665 ("McGinty"). "Gordon" did though, and he easily contrasted his opinion about where the income should be allocated, versus where most states' laws would allocate it. Tr. pp. 260-62 ("Gordon"). In this respect, it must be recognized that "Conglom's" formula is based almost entirely on "Gordon"'s opinion as to, inter alia, where "Conglom's" intellectual properties that were the subject of the licenses were used, and upon his conclusory testimony that, without such royalty and dividend income, "Conglom" would have had domestic losses during the years at issue. Tr. pp. 135-48, 260-61 ("Gordon"). "Gordon" himself acknowledged that most states disagreed with his opinion regarding the state to which income from intangibles should be attributed (*see* Tr. pp. 260-62), and the annual reports introduced at hearing show that "Conglom" had operating profits during each of the years at issue, when "Conglom's" intercompany transactions were eliminated. Department Exs. 112-114, p. 22 of each annual report.

Moreover, if the values "Conglom" uses in the numerator and denominator of its intangible property factor truly measured and compared the value of "Conglom's" intangible properties and where they were used, as described in Taxpayer Ex. 14, I would have to believe that none of "Conglom's" trademarks, patents and know-how were ever used within Illinois during the years at issue. That would mean, e.g., that no "Conglom" developed know-how was ever used in "Conglom's" or VCA-NY's Illinois warehouses during the years at issue. Similarly,

it would mean that the personnel who worked at "Conglom's" Chicagoland sales office, "PSI's" headquarters or "VCA-NY's" warehouse and sales office never used any of "Conglom's" trademarks when marketing the different consumer products that were sold and/or distributed from those locations in Illinois. I cannot and do not make that conclusion, however, because "Conglom's" trademarks are one of its most important assets (Department Exs. 116-117, p. 2 of each form 10-K), and because it uses at least one of its trademarks on all of the goods it manufactures and markets. *See* Tr. pp. 128-32 ("Gordon", describing "Conglom's" primary domestic brands) 356 ("Hearst").

All of "Conglom's" witnesses having personal knowledge of "Conglom's" licenses of trademarks and other intellectual properties, moreover, readily agreed that "Conglom" uses its trademarks wherever it does business around the world. Tr. pp. 128-32 ("Gordon"), 356 ("Hearst"), 547-48. That would include its business operations conducted within Illinois, although the record is also clear that, since many of the brands sold around the world are not also sold within the United States, "Conglom" does not use all of its trademarks in Illinois. *See* Tr. pp. 380-83 ("Hearst"), 503-10. Since "Conglom", "PSI" and "VCA-NY" marketed and/or distributed goods or services in and/or from Illinois during the years at issue using trademarks such as ""Conglom"", "Name #1", "Name #2" or "Name #3", "Conglom's" alternative formula — a formula which reflects that none of the intangible properties were used in Illinois during the audit period — does not accurately reflect "Conglom's" business activities in Illinois during that period. By including within its alternative formula a factor which assumes that no "Conglom"–owned trademarks or know-how were used in Illinois during the years at issue, "Conglom's" formula does not reflect reality.

The intangible assets that "Conglom" licensed to foreign subsidiaries certainly allowed those corporations to sell goods to consumers overseas, just as "Conglom's" use of many of the same assets helped "Conglom" sell goods to consumers in Illinois and within the water's edge of

the United States. While I trust "Gordon"'s testimony that none of "Conglom's" foreign licensees ever used any of "Conglom's" intellectual properties in Illinois during the years at issue, I do not find credible his opinion that *"Conglom"* never used any of those valuable intangible assets when conducting the various operations associated with warehousing, distributing and selling "Conglom's" consumer products from its Illinois locations. *See* Taxpayer Ex. 14; Tr. pp. 135-48, 260-64 ("Gordon").

3. The Combined Factor Yielded by "Conglom's" Alternative Formula Is Less Than The Comparative Ratio of "Conglom's" Total Domestic Payroll or Property Within Illinois

"Conglom" does not dispute that, for 1990, approximately 1.28% of its total water's edge property, approximately 2% of its total water's edge payroll and approximately 3.4% of its total water's edge sales were attributable to its activities in Illinois. Department Ex. 42, p. 1. Based on those undisputed facts, and using the statutory three-factor formula, approximately 2.5% of "Conglom's" combined net income is attributable to its activities in Illinois during 1990. *Id*. For 1991, approximately 1.1% of "Conglom's" total water's edge property, 2.2% of its total water's edge payroll and 3.6% of "Conglom's" total water's edge sales were attributable to its activities in Illinois. *Id*., p. 6. Based on those undisputed facts, and using the statutory three-factor formula, approximately 2.6% of "Conglom's" combined net income for that year is attributable to its activities in Illinois. *Id*. For 1992, approximately 1% of "Conglom's" total water's edge property, 1.8% of its total water's edge payroll and 3.4% of its total water's edge sales were attributable to its activities in Illinois. *Id*., p. 10. Based on those undisputed facts, and using the statutory three-factor formula, approximately 2.4% of "Conglom's" combined net income is attributable to its activities in Illinois during that year. *Id*.

Notwithstanding its agreement with the relative amounts of payroll, property and sales attributable to its activities in Illinois, "Conglom's" proposed alternative apportionment formula produces an average factor of 0.007105 for 1990, 0.010859 for 1991 and 0.004913 for 1992. Taxpayer Exs. 18-20, p. 9 of each exhibit. Even if one ignores the fact that approximately 3.5%

of "Conglom's" water's edge sales during the years at issue were attributable to Illinois, its formula would still not fairly and accurately reflect the level of "Conglom's" income producing activities conducted in Illinois. Thus, for each of the audit years, "Conglom's" alternative formula assigns a portion of its water's edge net income to Illinois that is less than the least of its statutory factors. "Conglom's" formula attributes a reduced percentage of its total combined net income to its operations in Illinois because the formula gives the intangible property factor the greatest proportionate share of the weight accorded each of the four factors, and because the value of "Conglom's" intangible property factor is always zero.

4. While Eschewing Worldwide Combination, "Conglom's" Alternative Formula Uses Its Foreign Licensee's Expenses To Calculate Net Royalty Income, And Its Intangible Factor Purports To Take Into Account The Value of Its Intangible Property Used Worldwide

"Conglom's" alternative formula discounts the amount of its royalty income using expenses incurred by the royalty payors, which expenses are also used to determine the amount of the foreign tax credit to which "Conglom" is eligible under federal income tax rules. Taxpayer Exs. 16, 18-20, pp. 1-2 (of exhibits 16-18); Tr. pp. 142-46 ("Gordon"). In this respect, one must recall that Illinois' apportionment factors are designed to take into account the expenses related to *the recipient's* activities that led to the production of the income at issue — and not the expenses related to the persons who paid the income at issue.

It is regarding this point that one can at least understand "Conglom's" desire to have the expenses related to its foreign corporations' production of the income with which they make royalty and dividend payments to their parent taken into account within the apportionment fraction. Recall that most of the foreign royalty paying licensees are subsidiaries within "Conglom's" global operations. Department Exs. 85-88; 141-42 ("Gordon"). Those subsidiaries are, no one disputes, part of "Conglom's" world-wide unitary business. Department Ex. 90; Tr. p. 199 ("Gordon"). Thus, it is understandable that "Conglom" views the foreign payors' expenses as

its (i.e., "Conglom's") expenses, and wants to take those expenses into account in its alternative formula. *See* Taxpayer Exs. 16-17; Tr. pp. 142-48 ("Gordon").

The countervailing consideration, however, about which "Conglom" is also fully aware, is that the income of the persons who made the royalty payments is not being included within the water's edge combined group's apportionable income. *See* Tr. pp. 136-38 ("Gordon"). That is to say, Illinois's water's edge method does not include the income produced overseas by "Conglom's" foreign subsidiaries and other royalty payors within "Conglom's" unitary pie, only certain of the amounts such persons pay to "Conglom". *See* 35 **ILCS** 5/203(b)(2)(*O*) (15% of the dividends paid by foreign subsidiaries owned less than 85% by "Conglom"; and no amount of dividends received from subsidiaries "Conglom" owns more than 85% of); Tr. pp. 294-95 ("Gordon"). Illinois' system of combined reporting for income tax purposes treats sales between a water's edge member and a foreign subsidiary like transactions between a unitary group member and any other domestic customer. Caterpillar Financial Services, 288 Ill. App. 3d at 400, 680 N.E.2d at 1088.

What the court in Caterpillar Financial Services recognized was that the Illinois General Assembly never intended to consider the expenses a foreign interest, dividend or royalty payor might have incurred when producing the income later used to make such payments to an Illinois taxpayer. *Id*. Illinois is apportioning the income of the domestic taxpayer, not the income of the foreign royalty dividend or interest payor. For the same reason, payments to a domestic taxpayer should not be apportioned using the expenses the *payor* incurred when earning the money it used to make such payments. "Gordon" claims to appreciate that point (*see* Tr. pp. 137-38 ("Gordon")), yet the alternate formula he devised takes into account the payors' expenses when apportioning "Conglom's" royalty and dividend income. Taxpayer Exs. 16-20; Tr. pp. 142-51 ("Gordon").

Moreover, the way to eliminate any potential distortion caused by a water's edge combination method such as Illinois', which includes within the water's edge combined net

income the receipts a domestic parent receives from a foreign unitary subsidiary, is to use world-wide combination to apportion the combined income of an entire world-wide unitary business. That method eliminates all inter-company sales between unitary members, so using that method would eliminate the royalty payments and dividends that are included, under the IITA, within "Conglom's" combined water's edge apportionable income. That, of course, was the method the Illinois supreme court embraced in Caterpillar Tractor Co. v. Lenkos, 84 Ill. 2d 102, 417 N.E.2d 1343 (1981). As "Conglom" correctly notes, however, the Illinois General Assembly shortly thereafter rejected worldwide combined apportionment as a matter of legislative policy. *See* Department Ex. 90. "Conglom", moreover, is adamant that it does not want to use that method when apportioning its world wide combined income for the years at issue, for the very rational reason that such a scheme would greatly increase the amount of tax "Conglom" would owe. Tr. pp. 177-79 ("Gordon"). "Conglom" only wants to use an alternative apportionment formula if it reduces its tax liability.

The question, therefore, is whether the formula "Conglom" prefers fairly and reasonably apportions to Illinois an amount of its combined net income that is in proportion with its business activities within the state. Miami Corp., 212 Ill. App. 3d at 708, 571 N.E.2d at 804; 35 **ILCS** 5/304(f); 86 Ill. Admin. Code § 100.3390(c). For all of the reasons set forth in this recommendation, briefly summarized here, I conclude that it does not.

"Conglom" has described itself in this matter as "… principally a marketing company focused on building brand quality, recognition and loyalty." "Conglom's" Brief, p. 5. In that capacity, "Conglom" considers its trademarks "… to be of material importance to [its] business; consequently the practice is followed of seeking trademark protection by all available means." Department Exs. 115-117, p. 2 of each form 10-K. Yet "Conglom's" proposed formula tends to ignore, or at least, it reduces to almost an afterthought, the traditional income producing activities and costs of performance related to the business income it earned from regularly licensing its integral business intangibles, and from holding the stock of its foreign subsidiaries in order to

manage the operations of its world-wide unitary business. Further, the formula's intangible factor does not take into account the actual value of the intangible properties used within Illinois versus the actual value of such properties used everywhere, and the formula uses the payors', not "Conglom's", expenses. "Conglom's" proposed formula, I believe, distorts the extent of its business activities in Illinois, by ignoring or excessively diminishing the comparative levels of its payroll, property and sales activities attributable to Illinois.

Conclusion

Fundamentally, "Conglom's" proposed alternative apportionment formula treats "Conglom's" trademarks, patents and know-how, and the stock of "Conglom's" foreign unitary subsidiaries, as properties which possess, in and of themselves, income producing qualities that can be dissociated from "Conglom's" other human and capital resources within the United States. On that point, "Conglom" is wrong. "Conglom" earns business income in Illinois because it or its subsidiaries have been successful in marketing its trademarked goods and services. Neither "Conglom" nor its subsidiaries markets or sells consumer or other goods and services without using some of "Conglom's" trademarks. Thus, the values associated with its intangible assets simply cannot be divorced from "Conglom's" unitary activities within the water's edge of the United States and within Illinois. Those assets are, simply, integral and inextricably tied to "Conglom's" sales within all of the jurisdictions in which "Conglom" operates, including its sales in Illinois. There is, therefore, no distortion caused by Illinois' statutory scheme of including the apportionable amount of such royalty and dividend income in "Conglom's" unitary pie, and by using § 304(a)'s three-factor formula to apportion such business income, by including the net receipts therefrom in the denominator of "Conglom's" Illinois sales factor.

I recommend that the Director finalize the Notice of Deficiency as revised by the parties' agreement, and that he deny "Conglom's" petitions for alternative apportionment.

1/8/01 _____

Date Administrative Law Judge